A FULL AND FAITHFUL MARRIAGE: THE SUBSTANTIALLY-ALL-THE-PROPERTIES REQUIREMENT IN A CORPORATE REORGANIZATION

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I. INTRODUCTION

In triangular mergers[1] and in "C" or asset-acquisition reorganizations,[2] the acquiring corporation must acquire substantially all the properties of the target corporation. The "substantially-all" requirement has come to mean that all of the operating assets of the target corporation must be moved into the acquiring corporation. If the target corporation retains a fragment of the business or retains cash sufficient to enter into a new business, the acquisition fails as a tax-free reorganization. The movement of the operating assets of the target corporation is "the very kind of continuity that is basic to a corporate reorganization."[3]

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[1]I.R.C. § 368(a)(2)(D)-(E).

[2]I.R.C. § 368(a)(1)(C). Referring to reorganizations by letter ("A" reorganizations for mergers, "B" reorganizations for stock acquisitions, "C" reorganizations for asset acquisitions, and "D" reorganizations for transfers to controlled corporations) derives from the subparagraphs of I.R.C. § 368(a)(1). This Article refers to reorganizations by these letters, even when discussing periods in which the Code organized them differently.

[3]Moffatt v. Commissioner, 42 T.C. 558, 578 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967).

The requirement that the target's business fully pass over prevents tax-free reorganizations through partial sales of its assets or business. Thus, a reorganization is a "commercial marriage," a pooling of the interests of two shareholder groups, one in which neither side sells out to the other. Substantially-all reorganizations, like natural marriages, are supposed to be full and faithful marriages. As a result, business activity outside the newly-created corporation after the marriage is inconsistent with a transfer of substantially all the properties of the target.

In addition, the substantially-all requirement looks through newly-created subsidiaries to identify the target. Absent this provision, an acquiring corporation could defeat the substance of the substantially-all requirement simply by creating a subsidiary that would be the target in the reorganization. Assets selected to be sold would be put into the subsidiary, while unwanted assets would be kept out. Only the selected assets would be part of the reorganization. Even if the transferor would have only low-basis stock of the acquirer and the acquirer have only low-basis assets, these results are still acceptable. Nevertheless, by looking through newly formed affiliates to apply the substantially-all requirement, current law prevents a target corporation from being customized in order to accomplish a selective sale. Showing that all of the operating assets of the historic business passed over to the newly-created corporation is an affirmative prerequisite that prevents tax-free reorganizations for custom-made targets.

The historic business test, inherent in current law, avoids much of the need for subjective inquiry. A newly formed subsidiary customized for a transfer of assets always has some possible business justification. The courts are not in a good position to separate the important from the pretextual claims. Looking to the historic business of the target would look through a newly formed corporation, although the corporation is deemed valid for state law and tax law and without inquiry as to the corporate intent in forming it. Looking to the historic business would also forgo any inquiry as to whether a sale of assets was merely imaginable, on one end of the spectrum, or had become a foregone conclusion, at the other end, when the nominal target was formed.

Tax law abhors subjective tests. Two taxpayers in the same economic position should, under sound doctrine, pay the same tax without regard to whether their thoughts are stained or pure. "Save in those matters where the statute itself turns on intent," Judge Friendly has written, "a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers."[4]

For better or worse, not all acquisitive reorganizations have a substantially-all-the-properties requirement under current law. Congress has presumed, for instance, that nontriangular "A" reorganizations, which are mergers under state law, and "B" reorganizations, where substantially all of the stock of the

[4] Lynch v. Commissioner, 273 F.2d 867, 872 (2d Cir. 1950) (using step-transaction doctrine to deny interest deduction on grounds debt was a sham).

target is held at the end of the transaction, would automatically qualify as full-fledged marriages, even without an explicit substantially-all requirement. This Article argues, however, that it would make sense for Congress to recodify current reorganization doctrine to require a strong substantially-all test for all acquisitive reorganizations, including the "A" and "B" reorganizations.

Part II, on the development of the historical business test, explains how and why the substantially-all-the-properties requirement came to refer to the operating assets of the historical business of the target. Part III, on ignoring separately-incorporated subsidiaries, explains how the law came to look through subsidiaries that are not "old and cold" and defends a per se test under which we would always look through new subsidiaries to apply the historic business test. Part IV, policy, argues that the substantially-all-the-properties requirement in this strong form should be applied by Congress to all reorganizations.

II. HISTORY: NOT FOR SALES, BUT FOR MARRIAGES

The function of the substantially-all requirement is to prevent a selective sale of assets by a target corporation from qualifying as a merger or consolidation, which would be entitled to nonrecognition. Reorganization treatment is limited, in part by the substantially-all requirement, to commercial marriages or fusions in which the business of the target passes over to the fusion or union corporation and the shareholders of the target continue their interest in the business in altered corporate form commensurate with the value they have given up. Subpart A describes the history by which the substantially-all-the-properties requirement evolved into the requirement that a reorganization preserve the target shareholder's continuity of interest in their business. Subpart B describes how the courts came to focus on the operating assets of the target within that framework.

A. *Deep Structure of the Substantially-All Requirement*

The language, "substantially all of its properties," came into the tax statute in 1921 as a requirement for what is now an asset-acquisition or "C" reorganization.[5] Congress used the phrase in 1954,[6] 1968,[7] and 1971,[8] as a requirement imposed on other kinds of reorganizations, without making any material

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[5]Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230. ("The word 'reorganization,' as used in this paragraph, includes . . . the acquisition by one corporation of . . . substantially all of the properties of another corporation . . . .").

[6]A reorganization is not taxed if "the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets . . . ." I.R.C. § 354(b)(1)(A) (1954).

[7]Act of Oct. 23, 1968, Pub. L. No. 90-621, 82 Stat. 1310 (creating I.R.C. § 368(a)(2)(D), which governs triangular merger reorganizations).

[8]Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077 (creating I.R.C. § 368(a)(2)(E), which governs "reverse" triangular merger reorganizations).

changes to the language, but has never delineated what will qualify as "substantially all the properties" nor under what theory qualification might be determined. The phrase draws meaning, however, from the continuity-of-interest doctrine[9] and its application within the statutory structure.[10]

The original use of the substantially-all-its-properties requirement was simply to ensure that a sale of assets eligible for tax-exemption bore some "real semblance" to a merger or unification of two corporations. After the rise of the continuity-of-interest doctrine, however, not all mergers qualified as reorganizations and Congress could impose the substantially-all requirement nonredundantly on transactions that were already mergers. Under the continuity-of-interest doctrine, a reorganization qualifies as tax free only if transferring shareholders receive an interest in the ongoing business commensurate with the business they gave up. The substantially-all requirement, together with the voting-stock requirement, tries to ensure an especially high level of continuity of interest in the business for the reorganizations subject to the substantially-all requirement. Within the doctrinal requirement that a reorganization must continue the transferor's interest in the business, the substantially-all-the-properties test shifted,

[9] *See* Bazley v. Commissioner, 331 U.S. 737, *reh'g denied*, 332 U.S. 752 (1947) (holding that "'recapitalization' must be construed with reference to the presuppositions and purpose of [I.R.C. § 368(a)(1)(E)]").

[10] *See* PHILIP BOBBITT, CONSTITUTIONAL FATE: THEORY OF THE CONSTITUTION 74 (1982) (discussing the legitimacy of structural explanations).

as discussed in the next subpart, to focus on the operating assets of the target's historic business.

1. *Like a Merger: 1918-1921*

A "C" or asset-acquisition reorganization is in form a sale of assets by the target corporation in exchange for stock of the acquirer. The idea that a transfer of assets by a target corporation could be like a fusion of two corporations originated in Treasury regulations in 1919. The Revenue Act of 1918 had created the first statutory reorganization provisions, providing that shareholders would recognize no gain in a "merger" if shareholders received stock with a par value that was not higher than that of the stock they gave up.[11] Regulations promulgated under the 1918 Act defined a "merger" qualifying for nonrecognition as a transaction in which "two (or more) corporations unite their properties" and then listed, as an example, "the sale of its property by *B* [corporation] to *A* [corporation in exchange for securities of *A* corporation] and the dissolution of *B*."[12] This example is the origin of the "C" or asset-acquisition reorganization.

In the Revenue Act of 1921, Congress adopted the idea from the regulations that an asset sale could be considered a

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[11]Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060.

[12]Reg. 45, § 1567 (1920).

unification of two corporations.[13] The 1921 Act also liberalized the rules. The 1919 regulations had required the target corporation to dissolve after giving up its assets. However, under the 1921 Act, the target did not have to dissolve.[14] The 1918 Act also had required that the par value of the stock that target shareholders received not be greater than the par value they gave up; the 1921 Act dropped the par value limitation.[15] Finally, the regulations had required the target to sell "its properties," without any explicit allowance for the target to keep some assets out of the unified corporation. The 1921 Act required only that "substantially all" of the target's assets be transferred in "C" reorganizations.[16]

The Supreme Court in 1935 applied the reorganization provisions to asset and stock acquisitions because they bore a "real semblance" to mergers and consolidations.[17] It was the substantially-all requirement that provided whatever semblance

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[13] Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230.

[14] The requirement that the target dissolve after transferring its assets was reinstated in 1984. *See infra* notes 84-85 and accompanying text.

[15] See BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 20-26 (3d ed. 1990), for a history of the decline in importance of the "par value of stock" limitation.

[16] Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230.

[17] Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935). This holding was based on language contained in the Revenue Act of 1928, ch. 852, § 112(i)(1)(A), 44 Stat. 791, 816, which defined a "reorganization" as a "merger or consolidation."

there is between a sale of the target's properties and a merger or consolidation.[18]

2. *Not for Isolated Sales: 1923*

Two years after adopting the substantially-all test, Congress removed the availability of like-kind nonrecognition for isolated exchanges of corporate stock and securities, leaving reorganization as the exclusive path by which shareholders could receive nonrecognition for corporate stock and securities. Congress adopted the predecessor of what is currently section 1031 in 1921, allowing a taxpayer to avoid recognition of gain or loss if the appreciated or depreciated property was exchanged for property of "like kind."[19] In 1923, Congress excluded "stock, bonds . . . or other securities" from like-kind nonrecognition.[20] The Ways and Means Committee explained that Congress was concerned about the selective use of nonrecognition:

> Under [pre-1923 law] taxpayers owning securities which have appreciated in value are exchanging them for other securities . . . but if the securities have fallen in value since acquisition [taxpayers] will sell them and

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[18] *See Minnesota Tea*, 296 U.S. at 385 ("[T]he seller must acquire an interest in the affairs of the purchasing company . . . . [T]his interest must . . . represent a *substantial part* of the value of the thing transferred[.]") (emphasis added).

[19] Revenue Act of 1921, ch. 136, § 202(c)(1), 42 Stat. 227, 230.

[20] Act of Mar. 4, 1923, ch. 294, 42 Stat. 1560.

> . . . deduct the amount of the loss on the sale. This result is manifestly unfair and destructive of the revenues.[21]

The benefit of nonrecognition for stock, bonds and securities was after 1923 to be limited to "those cases where the exchange is in connection with the reorganization, consolidation, or merger of one or more corporations."[22] Asset transfers by a target were thus kept as nonrecognition events because they were in the same category as mergers and consolidations.[23]

3. *Continuity of Interest in the Business: 1932-1936*

Between 1932 and 1936, the courts and Congress, working in tandem, developed the idea that reorganizations were to be distinguished from "mere sales" by the target shareholders' continuing interest in their former business. The substantially-all requirement came to be viewed as a part of the fabric serving to ensure that transferring shareholders received an interest in

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[21] H.R. REP. NO. 67-1432, at 1-2 (1923).

[22] *Id.* at 2.

[23] After 1923, the fact that a shareholder still had capital invested in like-kind stock was not a sufficient reason for nonrecognition treatment. *See* Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397 (1987); Marjorie E. Kornhauser, *The Origins of Capital Gain Taxation: What's Law Got to do with It?*, 39 SW. L.J. 869 (1985) (explaining that Eisner v. Macomber, 252 U.S. 189 (1920), suggested that gain should not be recognized because it was part of capital).

the ongoing union or fusion commensurate with the value of the business they gave up.

The continuity-of-interest doctrine began with the 1932 Second Circuit decision in *Cortland Specialty Co. v. Commissioner*.[24] In *Cortland Specialty*, the target corporation transferred its assets in exchange for short-term notes of the acquirer. The transaction was a "C" reorganization in form, a transfer of the target corporation's assets, and not a state-law merger.[25] Although a transfer of assets in exchange for "stock or securities" of the acquirer was considered a reorganization,[26] the court nevertheless held that the exchange was taxable to the target corporation.[27] "It might have been enough to hold that short term notes were not 'securities,'" as Learned Hand later described the case, "but [the court] went further and declared that the transaction was not a 'merger or consolidation . . . .'"[28] The term "reorganization," as used in the statute, was not intended to apply to a "mere sale" of assets.[29] In a true

[24]60 F.2d 937, 940 (2d Cir. 1932), *cert. denied,* 288 U.S. 599 (1933).

[25]*Id.* at 938.

[26]Revenue Act of 1926, ch. 27, § 203(h)(1)(B), 44 Stat. 9, 14. The language in this section is virtually identical to that in Revenue Act of 1921, § 202(c)(2), 42 Stat. 227, 230. *See supra* note 5.

[27]*See Cortland Specialty*, 60 F.2d at 940.

[28]Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[29]*Cortland Specialty,* 60 F.2d at 940.

reorganization, the transferring shareholders maintain a continuing interest in their business:

> In defining "reorganization," [the statute] . . . does not abandon the *primary requisite* that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms.[30]

The quoted language from *Cortland Specialty* has had an enormous impact on reorganization law, and the phrase, "continuity of interest in the business," has generated at least seven distinct arguments for disqualifying a reorganization, not all of which in fact disqualify it under current law:

> (1) *Nature of the consideration the acquiring corporation gives.* Some kinds of securities given by the acquiring corporation do not help maintain a continuing interest by the target shareholders in their business that has been acquired.[31]

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[30] *Id.* (emphasis added). *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (holding that an exchange of the target corporation's assets for the acquiring corporation's short-term notes was a taxable sale of the transferor's property rather than a "reorganization").

[31] *See, e.g.,* Revenue Act of 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 680, 705 (non-voting stock insufficient); Le Tulle v. Scofield, 308 U.S. 415, 421 (1940) (securities that did not give

(2) *Restrictions on percentage of taxable boot received.* Too much cash paid out to the target shareholders will prevent the target shareholders from maintaining a continuity of interest in their business.[32]

(3) *No business activities by the target after the reorganization outside of the fusion.* A business maintained by the target after the reorganization will mean that the transaction was not a full marriage or merger, but instead a disguised sale of selected assets by the target.[33]

(4) *Substantial portion of target's business enterprise must be continued in the fusion.* The acquirer may not abandon all of the target's old business after the reorganization.[34]

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target shareholders a "proprietary interest" were insufficient); *Pinellas Ice*, 287 U.S. at 468 (short-term notes insufficient); *Cortland Specialty*, 60 F.2d at 940 (short-term notes insufficient).

[32] *See* Rev. Proc. 77-37, 1977-2 C.B. 568 (no continuity of interest in a reorganization if cash represents more than 50% of the consideration).

[33] *See infra* notes 59-99 and accompanying text.

[34] *See, e.g.,* Reg. § 1.368-1(d)(2) (requiring the acquiring corporation to either "continue the acquired corporation's . . . historic business or . . . use a significant portion of [the acquired corporation's] historic business assets in a business"); Hendee v. Commissioner, 98 F.2d 934 (7th Cir. 1938) (holding that a merger was taxable because the business of the new corporation

(5) *Target shareholders may not sell stock of the fusion too quickly.* Target shareholders may not abandon the fusion too quickly pursuant to a prior plan.[35]

(6) *Remote continuity or indirect ownership is insufficient.* If target shareholders end up with stock of a parent corporation, which in turn owns the stock of the corporation that continues the target shareholders' old business, then the interest of the target shareholders in their business is indirect or remote and does not qualify as continuity of interest in the business.[36] The remote continuity objection has been eliminated.[37]

(7) *Most of the historic shareholders of the target must come over into the fusion.* The Tax Court has recently rejected the argument that historic

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bore no relationship to that of the old corporation). *See also infra* note 147.

[35]*See, e.g.,* McDonald's of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982). *But see* Bernard Wolfman, *"Continuity of Interest" and the American Law Institute*, 57 TAXES 840, 842-43 (1979); James Lynch, *Back to the Code: A Reexamination of the Continuity Doctrines and Other Current Issues in Reorganizations*, 73 TAXES 731, 765 (1995).

[36]*See, e.g.,* Helvering v. Bashford, 302 U.S. 454, 457-58 (1937); Groman v. Commissioner, 302 U.S. 82, 89 (1937).

[37]*See* I.R.C. § 368(a)(1)(B)-(C), (a)(2)(C)-(E) (allowing target shareholders to receive stock of the acquiring corporation).

shareholders of the target must continue into the fusion.[38]

These seven arguments function independently of one another. A transaction might pass many of the tests, but still fail to qualify as a reorganization. Some of the arguments are not now valid objections to a reorganization, while others are still living requirements. This Article is concerned only with the third, the requirement that treats business activity by the target after the marriage as inconsistent with the reorganization.

The Regulations were amended in 1935 to incorporate language from *Cortland Specialty* that required both a continuation of the business enterprise and continuity of the shareholders' interest in the business under modified corporate form.[39] The argument that the tax benefits of reorganization are not available for sales merely disguised as reorganizations has also been a recurring theme in reorganization law.[40]

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[38] *See* J.E. Seagram Corp. v. Commissioner, 104 T.C. 75, 101 (1995) (rejecting the argument that cash purchases by contending acquirers in a takeover battle prevent the eventual reorganization from receiving nonrecognition treatment) acquirer).

[39] Reg. 86, §112(g)-1 (1935) ("Requisite to a reorganization . . . are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the organization[.]").

[40] *See, e.g.*, Helvering v. Southwest Consol. Corp., 315 U.S. 194, 198-99 (1942); Le Tulle v. Scofield, 308 U.S. 415, 420 (1940); H.R. REP. NO. 73-704, at 14 (1934). *But see* Reg. 45, § 1567 (1920) (describing a "C" reorganization as a "sale").

In the Revenue Act of 1934, Congress endorsed the idea in *Cortland Specialty* that the target shareholders must participate in the acquiring corporation, which maintains a continuing interest in their transferred business. During the creation of the Act, a subcommittee of the Ways and Means Committee suggested repealing all of the provisions governing tax-free reorganizations.[41] In the end, however, Congress continued the tax-free reorganization, with the addition of provisions intended to "remove[] the danger that taxable sales can be cast into the form of a reorganization . . . ."[42] The 1934 Act was directed in part against "mere sales"[43] and the Ways and Means Committee, considering the Act, praised the courts for "a commendable tendency to look through the mere form of the transaction into its substance."[44]

The Revenue Act of 1934 specifically added the solely-for-voting-stock requirement: in an asset-acquisition (now a "C" reorganization) and in a stock-acquisition (now a "B"

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[41] SUBCOMM. ON TAX REVISION OF HOUSE COMM. OF WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 8 (Comm. Print 1933).

[42] H.R. REP. NO. 73-704, at 14.

[43] "[A]stute lawyers [have] frequently attempted . . . to take advantage of these provisions by arranging in the technical form of a reorganization, within the statutory definition, what were really sales." H.R. REP. NO. 73-704, at 13. *See Revenue Revision, 1934: Hearings Before the House Comm. on Ways and Means*, 73d Cong. ?? (1934) (statement of ?? Magil, Ass't Secretary, Treasury) (??"[T]he point that has bothered me about these reorganization provisions for 10 years, has been the great number of honest-to-goodness sales that have been carried out in the guise of these provisions, not really reorganizations at all").

[44] H.R. REP. NO. 73-704, at 13.

reorganization), the 1934 Act required that the acquirer use only its own voting stock to make the acquisition.[45]

The voting-stock requirement added for the "C" reorganization in 1934 is best understood as raising the level of continuity of interest maintained by the transferring shareholders in the fusion within the framework of *Cortland Specialty*. *Cortland Specialty* had stated that short-term notes were insufficient to give a continuing interest to the transferors.[46] Congress responded by going beyond *Cortland Specialty* by requiring that the transferors in a "C" reorganization receive voting stock of the fusion corporation to continue their interest in the business. The continuity-of-interest doctrine would later be applied to require that, even in mergers, the transferors had to have a "proprietary stake" in the fusion corporation, that is, that they receive at least some stock.[47] As a result, for "C" reorganizations, the 1934 Act had already gone beyond the requirement of some propriety stake to require that the transferors get only stock.

The new voting-stock requirement worked with the previous substantially-all requirement to ensure that the target shareholders obtain a participation in the fusion appropriate to the value that they brought into the marriage. The Supreme Court stated that even in a merger, the transferors must have "received

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[45] *See* Revenue Act of 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 680, 705.

[46] *See* 60 F.2d at 940 (debt securities alone are not sufficient).

[47] *See Le Tulle*, 308 U.S. at 421.

an interest in the affairs of the transferee which represented a material part of the value of the transferred assets."[48] For "C" reorganizations, the substantially-all requirement and the voting-stock requirement had combined to require that the transferors obtain a stock interest in the fusion corporation for substantially all of the value of the transferred business.

By 1936, the courts were using the substantially-all requirement and the continuity-of-interest doctrine as part of a single test to distinguish true reorganizations from "mere sales."[49] Both the voting-stock and the substantially-all requirements maintain the continuity-of-interest doctrine in the business "that is basic to a corporate reorganization."[50] As discussed in the next Part, "substantially all the properties" also came to be interpreted in continuity-of-interest terms, requiring a transfer of the business of the target corporation to the fusion corporation.[51]

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[48]*Minnesota Tea*, 296 U.S. at 386.

[49]*See* Western Indus. Co. v. Helvering, 82 F.2d 461, 462-63 (D.C. Cir. 1936) (holding that whether a corporation had transferred substantially all its properties was determined by whether the transaction was, like that in *Pinellas Ice*, a sale in substance).

[50]Moffatt v. Commissioner, 42 T.C. 558, 578 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

[51]*See, e.g.,* Commissioner v. First Nat'l Bank of Altoona, 104 F.2d 865, 870 (3d Cir. 1939) (holding that the substantially-all requirement was satisfied because all assets essential to the continuing operation of the business were transferred and those assets that were retained were never used to continue the old company), *cert. dismissed*, 309 U.S. 691 (1940); Schuh Trading Co. v. Commissioner, 95 F.2d 404, 408 (7th Cir. 1938) (holding that the substantially-all requirement was satisfied because "all elements of the . . . business of whatsoever character conducted

The tax-free reorganization has an analog in nontax financial accounting: the "pooling of interest" method of accounting for corporate acquisitions. This method draws on the continuity-of-interest doctrine in tax law. Under 1957 standards, for instance, the pooling-of-interest method was described as available where substantially all of the ownership interests in the constituent corporations become owners of the fusion corporation.[52] Pooling of interest, under the 1957 standards, has been described as a commercial marriage between two shareholder groups in which neither constituent has purchased or sold out to the other.[53] Thus the tax-free reorganization, including the asset sale "C" reorganization, is conceptualized as a commercial marriage between two corporations.[54] The substantially-all requirement makes the asset sale resemble a natural marriage.

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by it for a long period of years" were transferred); Gross v. Commissioner, 88 F.2d 567, 569 (5th Cir. 1937), *rev'g* 34 B.T.A. 935 (1936) (holding that the substantially-all requirement was satisfied because "[a]ll the properties . . . useful in [the] business . . . were transferred entire [sic] to the new corporation with intent that the business be continued"); Southland Ice Co. v. Commissioner, 5 T.C. 842, 850 n.4 (1945) (construing the substantially-all requirement as a "continuity test rather than [one of] mere blind percentages").

[52]*See Business Combinations*, Accounting Research Bulletin 48, §§ 1, 3 (Comm. on Accounting Procedure, American Inst. of Certified Pub. Accountants 1957). The requirements for a pooling of interest were later tightened. *See Business Combinations*, Accounting Principles Board Opinion No. 16 30 (Fin. Accounting Standards Bd. 1970). See also *infra* note 234 for discussion of how nontax "nonrecognition" under the pooling-of-interest method relates to tax "nonrecognition" under reorganization law.

[53]*See* William P. Hackney, *Accounting for Mergers and Acquisitions Under the New Jersey Business Corporation Act*, 23 RUTGERS L. REV. 689, 691 (1969).

[54]Neither a commercial marriage (a reorganization) nor a natural marriage are recognition events. A husband and wife can

4. *Continuing Echo of the Like-a-Merger Rationale*

The Revenue Act of 1934 helped create and nurture the new continuity-of-interest doctrine, but it is also rested on an earlier rationale to ensure that the asset acquisition bore "real semblance" to a merger. *Cortland Specialty* had been an asset acquisition, not a merger under state law. The new voting-stock requirement was imposed by the 1934 Act to "C" reorganizations and "B" reorganizations, but not to acquisitive "A" reorganizations that already qualified as mergers under state law.[55] Similarly, the substantially-all-the-properties requirement of the 1921 Act applies to the "C" reorganization but not to the "A" reorganization, state-law mergers. In a transaction that is a merger in form under state law, the target disappears and all of the assets move over to the surviving corporation by operation of law. If the only purpose of the voting-stock and substantially-all rules was to ensure that the "B" and "C" reorganizations were like mergers, then it would be redundant to apply the rules to a true merger and Congress in 1934 did not. In 1934, there was

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each bring substantial assets to the marriage so that each spouse is enriched by sharing the assets. This "pooling," however, is not a taxable event.

[55]In 1934, the House of Representatives considered repealing all of the nonrecognition provisions for "B" reorganizations and "C" reorganizations. The Senate, however, prevented their repeal by arguing that not all states had merger statutes or allowed corporations from two different states to merge. *See* S. REP. NO. 73-558, at 16.

plausibly nothing in the continuity-of-interest doctrine that would not be satisfied by qualification as a state-law merger.

In the years after 1934, however, the new and developing doctrine of continuity of interest would be applied even to disqualify transactions that were state-law mergers.[56] The courts came to look beyond the state-law corporation nominally involved in the merger to see whether substantially all of the operating assets of the historic business passed over.[57] By 1968, Congress imposed the substantially-all requirement on transactions that were already mergers under state law, without being redundant.[58] Qualification as a state-law merger came to be insufficient to ensure that the substantially-all requirement was met. The transaction also had to maintain the shareholder's continuing interest in the business that was passed over to the fusion or marriage corporation.

B. *"Substantially All" Means the Operating Assets of the Historical Business*

1. *Not Blind Percentages: 1936-1939*

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[56]*See* Roebling v. Commissioner, 143 F.2d 810, 812-14 (3d Cir.), *cert. denied*, 324 U.S. 773 (1944).

[57]*See* Helvering v. Elkhorn Coal Co., 95 F.2d 732, 735 (4th Cir.), *cert. denied*, 305 U.S. 605 (1938). *See also infra* notes 114-34 and accompanying text.

[58]*See, e.g.,* I.R.C §§ 368(a)(2)(D)-(E). *See also infra*, notes 135-44 and accompanying text.

With the introduction of the argument that continuity of shareholder interest in the business was a "primary requisite" of a reorganization,[59] the courts began to look at the substantially-all requirement in terms of continuing interest in the business. The requirement came to focus on whether there was a transfer of the business of the target to the acquiring corporation. The substantially-all requirement was "subjected to [a] construction which in effect applies a continuity test rather than mere blind percentages."[60] The test would be satisfied when there is "the most complete continuity of enterprise--the very kind of continuity that is basic to a corporate reorganization . . . ."[61] Substantially all of the properties were transferred, the courts said, when all assets "necessary and appropriate,"[62] "useful,"[63] or "essential"[64] to the business are transferred.[65] "[T]he assets

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[59]*Cortland Specialty*, 60 F.2d at 940 (quoted in text accompanying note 29). *See also Moffatt*, 42 T.C. at 578 (quoted in text accompanying note 50).

[60]*Southland Ice*, 5 T.C. at 850 n.4. *See* American Mfg. Co. v. Commissioner, 55 T.C. 204, 221 (1970); Wilson v. Commissioner, 46 T.C. 334, 345 (1966); *Moffatt,* 42 T.C. at 578. *But see infra* note 71 (citing cases that argue that only 80% of assets must be transferred).

[61]*Moffatt*, 42 T.C. at 578. *See also Schuh*, 95 F.2d at 408.

[62]*American Mfg.*, 55 T.C. at 221; *Wilson*, 46 T.C. at 345; *Moffatt*, 42 T.C. at 579.

[63]*Gross*, 88 F.2d at 569.

[64]James Armour, Inc. v. Commissioner, 43 T.C. 295, 308 (1964); *First Nat'l Bank of Altoona*, 104 F.2d at 870.

[65]There are no distinctions among "necessary and appropriate," "useful," and "essential." Each of these terms allows corporations to retain surplus cash for distribution to creditors and shareholders. Moreover, the courts have neither

looked to when making the 'substantially all assets' determination should be all the assets, and only the assets, necessary to operate the corporate business . . . ."[66]

The shift of focus from a mechanical test, looking to the percentage of assets transferred, to a functional test, looking to the transfer of the business of the target, is traceable to five cases decided between 1936 and 1939. Early substantially-all-the-properties cases focused only on the percentage of assets transferred and retained or on the absolute amount of the assets that were not passed over from target to fusion corporation, without regard to the use of the retained assets.[67] Consistently, in 1935 the Supreme Court held that a "C" reorganization was valid even though the target remained in existence and continued to do business.[68] Soon thereafter, however, the lower courts began to hold that a transfer in which the target continued in business

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defined "necessary" narrowly nor defined "useful" broadly. *Compare American Mfg.*, 55 T.C. at 221 *with Gross*, 88 F.2d at 569.

[66]Smothers v. United States, 642 F.2d 894, 900 (5th Cir. 1981). *But see id.* at 902 (Garza, J., dissenting) ("[I]f Congress had meant 'necessary operating assets' it would have said so instead of specifically requiring that 'substantially all' of the assets be transferred[.]"); *Moffatt*, 363 F.2d at 270 (Craig, J., dissenting) ("[I]f Congress intended to limit the transfer to 'operative assets' it would have said so. Congress did not, and the Court should not read into the Code that which is not there[.]").

[67]*See* Arctic Ice Mach. Co. v. Commissioner, 23 B.T.A. 1223, 1228-29 (1931) (holding that a transfer of 68% of assets was not a transfer of substantially all assets).

[68]*See* G. & K. Mfg. Co. v. Helvering, 296 U.S. 389, 391 (1935) ("The mere fact that the taxpayer and its subsidiaries continued actively in business would not defeat the claim of reorganization[.]").

could not be of substantially all the properties because the target continued to do business.

The court in *Western Industries v. Commissioner*[69] suggested that the substantially-all requirement concerned the target corporation's business. The court held that the asset acquisition was tax-free, because the target corporation "went out of business as an operating corporation and continued thereafter . . . as a holding corporation."[70] The assets retained by the target in *Western Industries* were only fifteen percent of the total assets, which might have been small enough to be insubstantial under a straight percentage test.[71] In the later cases in the sequence, however, the courts held that the assets retained were too large to be considered insubstantial as a matter of blind percentages but they still allowed the reorganization to qualify under the new focus on the business of the target.

In *Smith v. Commissioner*,[72] the target of a "C" or asset-acquisition kept twenty-nine percent of its assets to pay off its liabilities,[73] a percentage that would not have satisfied the substantially-all requirement under a straight percentage focus.

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[69]82 F.2d 461 (D.C. Cir. 1936).

[70]*Id.* at 464.

[71]Courts, using "blind percentages," had indicated that transferring 80% of assets satisfied the substantially-all requirement. *See, e.g., Gross*, 34 B.T.A. at 401; *Moffatt*, 363 F.2d at 270 (Craig, J., dissenting). *Cf*. I.R.C. § 368(c) (defining "control" as ownership of at least 80% of voting and nonvoting stock).

[72]34 B.T.A. 702 (1936).

[73]*Id.* at 703-04.

The Board of Tax Appeals held, however, that twenty-nine percent of the assets held back did not defeat the reorganization because "[n]o assets were retained for purpose of engaging in any business or for distribution to stockholders."[74] The Board distinguished prior cases and hypotheticals posed by the government where the "transferor corporation might continue in business"[75] or use its retained assets for "the inauguration of a different line of business."[76] After *Smith*, the substantially-all requirement allowed the target corporation to retain a large amount of cash to pay its liabilities, provided that the all of the operating assets passed over.[77]

In *Gross v. Commissioner*,[78] the third case in the change in focus, the Board of Tax Appeals held that retention of twenty percent of the assets was too much for the transaction to qualify under the substantially-all test.[79] However, the Fifth Circuit

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[74] *Id.* at 706.

[75] *Id.* at 705.

[76] *Id.*

[77] *See, e.g.,* Payson v. Commissioner, 166 F.2d 1008, 1010 (2d Cir. 1948); Nelson v. United States, 69 F. Supp. 336, 339 (Cl. Ct. 1947); Roosevelt Hotel Co. v. Commissioner, 13 T.C. 399, 408 (1949); Taylor v. Commissioner, 43 B.T.A. 563, 567 (1941), *aff'd sub nom.,* Helvering v. Taylor, 128 F.2d 885 (1942); American Cent. Mfg. Co. v. Commissioner, 8 T.C.M. (CCH) 368, 1949 T.C.M. (P-H) ¶ 49,091; Rev. Rul. 57-518, 1957-2 C.B. 253.

The Service considers a corporation's decision to retain assets in order to pay liabilities a factor in satisfying the substantially-all requirement. *See* Rev. Proc. 77-37, 1977-2 C.B. 568 (after liabilities are paid, at least 90% of net assets and 70% of gross assets, ignoring liabilities, must be transferred in order to satisfy the substantially-all requirement).

[78] 34 B.T.A. 395 (1936).

[79] *Id.* at 401.

reversed,[80] holding that the transaction qualified because the business had passed over to the union:

> All the properties of Tampa Box Company useful in its business including such cash as was needful for working capital, were transferred entire [sic] to the new corporation with intent that the business be continued. The surplus cash assets, though property in a broad sense, were such as might have been paid out as an ordinary cash dividend before the transfer and were not a substantial part of the business "properties" of the Tampa Box Company.[81]

Similarly, in *Schuh Trading Co. v. Commissioner*,[82] the Board of Tax Appeals held that retaining eighteen percent of the assets of the target was too large to qualify the passed assets as "substantially all" on the straight percentages.[83] However, the Seventh Circuit reversed,[84] recomputing the percentage of retained assets to be only six percent of total assets once guarantees made in the sale were satisfied by the target. The court also held that the substantially-all requirement was satisfied because the target "delivered to the transferee all elements of the

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[80] 88 F.2d 567 (5th Cir. 1937).

[81] *Id.* at 569.

[82] 5 B.T.A. Mem. Dec. (P-H) ¶ 36,245 (1938).

[83] *Id.* at 352.

[84] 95 F.2d 404, 408-09 (7th Cir. 1938).

wholesale drug business of whatsoever character conducted by it for a long period of years."[85]

Finally, in *Commissioner v. First National Bank of Altoona*,[86] the Third Circuit held that retaining fourteen percent of total assets satisfied the substantially-all requirement because the transferred assets included "all of the assets essential to the operation of [the transferor's] business of distributing gasoline"[87] and the retained assets were distributed to shareholders and "never used to continue the old company in business . . . ."[88] After *Gross* and *Altoona*, cash representing even a large percentage of the target corporation's original assets could be distributed to its shareholders without failing to satisfy the substantially-all requirement.[89]

2. *Liquidation-Reincorporation Cases: 1964-1983*

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[85] *Id*. at 408.

[86] 104 F.2d 865 (3d Cir. 1939), *cert. denied*, 309 U.S. 691 (1940).

[87] *Id.* at 870.

[88] *Id.*

[89] *See Smothers*, 642 F.2d at 901 (holding that liquid assets distributed to shareholders did not negate the disputed reorganization). The court in *Smith* stated that retaining assets "for distribution to stockholders" was prohibited by the substantially-all requirement; nevertheless, later courts allowed corporations to retain liquid, non-operating assets for distribution to stockholders. *See* Robert H. Wellen, *New Guidance is Needed for the "Substantially All" Rule as Applied to Acquisitions*, 79 J. TAX'N 280, 283 (1993).

The focus on the transfer of the business of the target corporation is clearest--and the most dramatic retentions were allowed--in the "liquidation-reincorporation" cases, decided many years after the focus shifted from pure percentages to the business.

The liquidation-reincorporation cases are those in which reorganization character is applied in favor of the government and against the taxpayer's will. The doctrine is aimed at sham liquidations. A liquidation of a corporation can bring a significant tax advantage to shareholders. Distributions of earnings and profits by a corporation are usually ordinary income dividends. Upon liquidation, however, prior earnings and profits of the corporation are distributed as tax-free recovery of basis and then as capital gain. Often, however, liquidations created for tax purposes are quite sham-like. The operating assets distributed in liquidation reappear in a new corporation owned by essentially the same shareholders and the same business enterprise is continued, often without any interruptions perceptible to outsiders. The courts have responded by finding that such liquidations are not liquidations for tax purposes at all, but are instead "nondivisive D" reorganizations, transferring substantially all of the properties of the enterprise from the old corporation to the new corporation controlled by the transferor or its shareholders.[90] Surplus cash

[90] *See* I.R.C. §§ 354(b), 368(a)(1)(D). See also Richard Westin, *In Like a Lion and Out Like a Lamb: the 98th Congress and the Liquidation-Reincorporation Abuse*, 63 TAX NOTES 997 (1989), for a discussion emphasizing the awkward fit between the

kept by the shareholders in the switch of the enterprise from old corporation to new is then considered to be an ordinary-income distribution received in the course of the reorganization, rather than favorably-taxed capital gain from a complete liquidation.[91]

Within the context of the anti-abuse liquidation-reincorporation doctrine, the percentage of assets kept out of the surviving corporation came to be a larger and larger percentage of the original corporation. The assets that needed to be passed over to the survivor, conversely, came to be a smaller and smaller percentage of the original business. In 1964 and 1966, the courts held that the substantially-all requirement was satisfied even though approximately thirty-five percent of the corporation's assets did not pass over.[92] From 1970 to 1983, courts were willing to hold that the substantially-all requirement was satisfied even though eighty to eighty-five percent of the original corporate assets were kept by the shareholders and that only fifteen to twenty percent of the corporation's assets passed over to the successor corporation.[93] Even more dramatically, in service businesses the most important

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statutory language of the "reorganization" remedy and the sham liquidation abuse.

[91]As a result, I.R.C. § 356(a)(2) (governing dividends within gains), rather than I.R.C. § 331 (governing capital gains), controls the transaction.

[92]*See Armour*, 43 T.C. at 309; *Moffatt*, 363 F.2d at 267.

[93]*See, e.g., Smothers*, 642 F.2d at 898 (15% of assets transferred); Atlas Tool Co. v. Commissioner, 614 F.2d 860, 864 (3d Cir. 1980) (19% of assets transferred); Vierick v. United States, 3 Cl. Ct. 745, 753 (1983) (20% percent of assets transferred); *American Mfg.*, 55 T.C. at 221-22 (less than 20% of assets transferred).

assets of the business are often the skills of the principal owners and the value of a trained work force--assets which are not even listed on the balance sheet.[94] For those businesses it is conceivable that the courts would find that substantially all the properties were transferred because the business enterprise passed over, even if no tangible assets are transferred. In 1981, for instance, the Fifth Circuit held that a transaction claimed to be a liquidation was instead a reorganization because "[t]he same business enterprise was conducted by the same people under the same ownership, and the only assets removed from corporate solution were accumulated liquid assets unnecessary to the operation of the business."[95]

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[94] *See Moffatt*, 42 T.C. at 578-79.

[95] *Smothers*, 642 F.2d at 901. For other examples of language focusing on the business enterprise, see Rose v. United States, 640 F.2d 1030, 1034 (9th Cir. 1981) (all operating assets transferred); *Atlas Tool*, 614 F.2d at 865 (focusing "on the operating assets . . . and not on the unneeded liquid assets such as cash and accounts receivable"); *Vierick*, 3 Cl. Ct. at 755 (all operating assets transferred, even though they were only 20% of total assets); Tel. Answering Serv. Co. v. Commissioner, 63 T.C. 423, 436 (1974) (holding that the transaction was a reorganization, and not a liquidation, because the operating assets were transferred into a corporation owned by the same interests), *aff'd*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977); *American Mfg.*, 55 T.C. at 222 (retained assets "were not necessary to the conduct of the business"); *Moffatt*, 42 T.C. at 579 (holding that the transaction was a reorganization because there was complete continuity between businesses); *Wilson,* 46 T.C. at 345-46 (all the assets that were necessary or appropriate to the conduct of the" insurance agency were transferred to the new business; assets not transferred were cash receivables and investment stock "'not necessary to the conduct of the enterprise'") (quoting *Armour*, 43 T.C. at 309); *Armour*, 43 T.C. at 309 (new corporation acquired "all the assets essential to the conduct of the business enterprise" and the assets that it did not acquire, "cash and accounts receivable, were not necessary to the conduct of the enterprise").

The liquidation-reincorporation doctrine is an anti-abuse doctrine that might not be fully symmetrical[96]--taxpayers may not be able to rely on the cases where trivial tangible assets pass over, when taxpayers want reorganization treatment. Still the focus on the operating assets of the historical business is established doctrine, whether the decision favors taxpayer or government.

3. *No Outside Business*

After the shift in focus to look to the target's business enterprise, the target could retain very substantial assets either to pay off creditors or to distribute to shareholders. What would poison the reorganization, however, were assets retained "for the purpose of engaging in any business."[97] Assets allowed to be retained must "never [be] used to continue the old company in business."[98] The substantially-all reorganization fails when the corporation keeps enough cash in corporate form that "it seems likely that the corporation may have contemplated the continuation of its business or the sale of the remainder of its operating assets to another purchaser."[99] *National Bank of*

[96]*See* Westin, *supra* note 90.

[97]*Smith*, 34 B.T.A. at 706; *see also* Rev. Rul. 57-518, 1957-2 C.B. 253, 254.

[98]*First Nat'l Bank of Altoona*, 104 F.2d at 870.

[99]Rev. Rul. 57-518, 1957-2 C.B. at 255.

Commerce of Norfolk v. United States,[100] for instance, held that a transfer was not a substantially-all reorganization where the target corporation kept just nineteen percent of its assets, because the retained assets were ordinary operating assets, useful to the business.[101] Before 1984, there was no requirement that the target liquidate as a state-law corporation after a "C" reorganization,[102] but the target had to go "out of business as an operating corporation"[103] and continue thereafter only "as a [passive] holding corporation"[104] to meet the substantially-all test.

4. *Target Must Dissolve: 1984*

In 1984, Congress required that the target of a "C" reorganization liquidate after transferring substantially all its properties.[105] This change is best understood as codifying the

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[100] 158 F. Supp. 887 (E.D. Va. 1958).

[101] *Id.* at 895.

[102] *See Minnesota Tea*, 296 U.S. at 386. The elimination of the liquidation requirement in the Revenue Act of 1921 suggests that the target corporation could continue to exist after it exchanged its operating assets for stock. *See supra* notes 11 & 13 and accompanying text.

[103] Western Indus. Co. v. Helvering, 82 F.2d 461, 464 (D.C. Cir. 1936); *see also* Rev. Rul. 68-358, 1968-2 C.B. 156.

[104] *Western Indus.*, 82 F.2d at 464.

[105] Tax Reform Act of 1984, Pub. L. No. 98-369, § 63, 98 Stat. 583, 583. This Act created I.R.C. § 368(a)(2)(G). The target corporation may, with permission of the Department of Treasury, avoid actual liquidation, provided that it is a lifeless shell that has been liquidated in substance. *See* I.R.C. § 368(a)(2)(G)(ii); Rev. Proc. 89-50, 1989-2 C.B. 631. *See*

traditional judicial requirement that the target may not conduct business affairs outside of the fusion corporation after a commercial marriage has taken place.[106] The Senate Finance Committee stated that the rationale for requiring dissolution of the target was that Congress was concerned that after a "C" reorganization, the target corporation might otherwise "be able to engage in an active trade or business and not merely serve as a holding company for its shareholders' interests."[107] Requiring a liquidation is a prophylactic rule that confirms the rationale, inherent before the 1984 amendments, that all the business activity take place after the exchange in the fusion corporation and that business activity by the target outside of the fusion after the transfer destroys the substantially-all-the-properties reorganization.

A reorganization with a substantially-all-the-properties requirement is, then, like a marriage in that it must be whole-hearted and exclusive.[108] In a valid substantially-all reorganization, all of the business activity must take place, after the marriage, within the fusion corporation. The separate

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generally BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.24[4] (6th ed. 1994).

[106]This change was conceivably a reaction to Rev. Rul. 73-552, 1973-2 C.B. 116, which held that a target corporation may use retained liquid assets (presumably an insubstantial fraction of total assets) to enter a new active business. The ruling neither cited nor considered the traditional judicial focus on operating assets of the target corporation and, therefore, appears erroneous.

[107]S. REP. NO. 98-169, at 204-05 (1984).

[108]*See* Hackney, *supra* note 53, at 691.

business conducted by the target corporation after reorganization prevents the target shareholders from completely pooling their interests and maintaining an interest in the new business. A business conducted in the target corporation after the reorganization means that the original reorganization was a selective sale of assets and not a full and faithful marriage.

5. *Replacement Asset Ruling: 1988*

In Revenue Ruling 88-48,[109] the Service ruled that a target could sell off unwanted assets to a third party and pass over the rest of the assets in a valid reorganization subject to the substantially-all requirement, so long as the cash proceeds of the taxable sale were also passed over to the acquirer. The target sold one complete business and passed over another in the reorganization, but nothing in the reasoning of the ruling seems to depend upon whether the sold or reorganization assets constitute a complete business.[110] The articulated rationale for the ruling is that the function of the substantially-all requirement is to identify reorganizations that are not essentially divisive in nature. Divisive reorganizations are supposed to pass the barriers found in section 355. Since the cash proceeds in the ruling were replacement assets that passed over to the acquirer, the reorganization was not essentially

[109] 1988-1 C.B. 117.

[110] Under I.R.C. § 355, tax-free corporate divisions are permitted if both fragments of the corporation after division are

divisive and did not need to be tested by the section 355 requirements.

There undoubtedly needs to be considerable tolerance for changes in the historic business in the years prior to the reorganization. At one end of the spectrum, an ordinary business is always selling inventory and the sales neither change the nature of the underlying business nor prevent the heart of the business from passing over in the reorganization. Still, at the other end of spectrum, Revenue Ruling 88-48 seems too generous. When the substantially-all-the-properties language is used in section 354(b)(1)(A) of the Code, its function is to require divisive reorganizations to pass through the section 355 standards.[111] That is not, however, the only function of the substantially-all language within the asset acquisition and triangular merger. The substantially-all test within the "C" reorganization dates back to periods when tax-free divisive reorganizations were freely allowed by the Code,[112] which implies that there was no prohibition on divisive nature in the substantially-all test or anywhere else. The test continued without amendment through periods when divisive reorganizations

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complete active businesses. As a result, the transaction would have been proper even if it had been a division.

[111] *See* S. Rep. No. 83-1622, at 265 (1954).

[112] Revenue Act of 1924, ch. 234 § 203(g), (h)(1)(B), 43 Stat. 253, 257, allowed a corporation to form a subsidiary and distribute its assets without being taxed, essentially a tax-free fission of the original corporation. This provision was repealed by the Revenue Act of 1934, apparently in response to *Gregory*; it did not reenter the Code until 1951. *See* Bittker & Eustice, *supra* note 105, at ¶ 11.01[2].

were prohibited in full and also into periods when divisive reorganizations were allowed but subject to the section 355 restrictions. The requirement that all of the operating assets of the historic business pass over into the fusion comes from *Cortland Specialty*, which was not a divisive reorganization in either form or substance.[113] The abuse in *Cortland Specialty* was not a division of the corporation, but a mere sale of assets disguised as a marriage. Acquisitive reorganizations flunk the continuity-of-business requirement, not only because they are divisive, but because they are disguised sales and not full mergers or marriages.

The function of the substantially-all test seems to be to ensure that a "C" reorganization is not a selective sale of some assets by the target corporation, but bears some resemblance to a commercial marriage or pooling between two groups of shareholders. The requirement screens out selective sales of assets by the target. A transaction in which the target sells all of its loss property to recognize the tax loss and transfers over its gain property, claiming nonrecognition of the gain, seems to violate the purpose of the requirement.[114] The anti-cherry-picking

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[113] 60 F.2d at 940.

[114] *See* H.R. REP. NO. 67-1432, at 1-2 (1923); *Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 46 (acquisitions of "only selected assets, operations, or ownership interests" of the target corporation do not qualify for the pooling-of-interests method of accounting). *See also supra* note 21 and accompanying text. *Cf.* FEDERAL INCOME TAX PROJECT: SUBCHAPTER C 98-99 (American Law Institute 1982) (restricting otherwise elective corporate nonrecognition transactions to prevent situations in which some assets are not taxed, while others are taxed).

and the full-commercial-marriage functions of the substantially-all requirement, unfortunately, do not then lead to clear and inevitable lines distinguishing pre-reorganization sales by the target that still allow the historic business to pass over from those sales that prevent the reorganization from being a full and faithful marriage. Some taxable sales in preparation for a reorganization should eviscerate the reorganization, notwithstanding Revenue Ruling 88-48, and some should not.

For the present, however, Revenue Ruling 88-48 seems to legitimate pre-reorganization sales of the historic business or any part of it, so long as the proceeds of the sale then pass over into the fusion. The historic business is redefined to include the proceeds of the taxable sale. In Revenue Ruling 88-48, however, the target was not involved in any post-fusion business affairs, outside of the marriage. The impact of the requirement that the target pass over its business to the fusion corporation, then, is to prohibit business affairs by the target outside the confines of the fusion corporation or marriage.

III. LOOKING BEYOND THE STATE-LAW TARGET

The substantially-all requirement mandates that the target transfer all of the operating assets of the historic business and means that the courts will commonly need to look beyond the confines of the nominal target corporation, that is, the state-law corporation that made the transfer. The courts will require that all of the historic business pass over into the marriage, even if the retained operating assets are found in a separate affiliated corporation that is respected as separate by the tax law. Subpart A analyzes *Helvering v. Elkhorn Coal Co.*,[115] a case which ignored corporations set up in anticipation of sale. Subpart B argues that the focus on the operating assets of the historic business of the corporation will mean the courts will treat some subsidiaries as transparent in applying the substantially-all test, even when the subsidiary is respected as a bona fide by tax law.

A. *Beyond the Borders of the Nominal Target*

1. Elkhorn: *1938*

Beginning with *Elkhorn*, courts have looked through fissions of the target and new subsidiary corporations formed in preparation for the reorganization to identify the target's historic business and to ensure that the operating assets of the business have passed over.[116] In *Elkhorn*, the target corporation of a "C" reorganization decided to combine its mining operations in Maybeury, West Virginia, with the operations of another corporation that owned a neighboring mine.[117] The target, Elkhorn

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[115]95 F.2d 732 (4th Cir.), *cert. denied*, 305 U.S. 605 (1938).

[116]See subpart B.4, *infra*, for a discussion of the issues involved in identifying the "historic" business. It argues that "historic" might mean only five years before the reorganization and, therefore, does not imply true antiquity.

[117]95 F.2d at 733.

Coal, however, also operated mines away from Maybeury, which were not to be combined.[118] Pursuant to that business purpose, the old Elkhorn corporation split in two in preparation for the "C" reorganization.[119] The non-Maybeury mines were transferred to a new subsidiary corporation and the shares of the subsidiary were distributed to the shareholders.[120] Only the Maybeury mine and related properties were left in the target corporation and only those properties were transferred over to a fusion corporation in exchange for stock of the acquiring corporation.[121] *Elkhorn* thus involved a division of the target corporation in preparation for the acquisition, with a spin-off of the unwanted business so that only the wanted business (the Maybeury mines) remained in the target to be acquired.

The court in *Elkhorn* held that the transfer of the Maybeury mines was taxable because it failed the substantially-all test.[122] All of the properties of the state-law target corporation were transferred. The split-up of Old Elkhorn and the acquisition, however, were not separate and distinct steps, the court held, but rather substeps within a larger transaction to sell only part of the original Elkhorn properties.[123] The court cited the then-

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[118] *Id.*

[119] *Id.*

[120] *Id.* at 733-34.

[121] *Id.* at 734.

[122] *Elkhorn*, 95 F.2d at 735.

[123] *Id.* at 734-35.

recent *Gregory* case, involving a step-transaction.[124] Once the separate steps of forming a new corporation for part of the assets were collapsed into the larger transaction, the court recognized that the substance of the transaction, ignoring the form, was that substantially all of the properties of the original Elkhorn corporation had not passed over into the fusion corporation.[125]

Elkhorn was decided in 1938, in the middle of the period during which the courts shifted their focus from what percentage of the target's assets were retained to whether the target's business was transferred.[126] The decision did not cite the post-shift cases that focused on the operating assets of the target business. Nonetheless *Elkhorn* certainly makes sense within the focus on the operating assets of the historic business. The transaction failed the substantially-all requirement because the non-Maybeury mines kept by the target shareholders meant that all of the operating assets of the historic *Elkhorn* business did not pass over to the fusion. The transaction was a selective sale of

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[124]*Id.* In *Gregory*, the taxpayer removed marketable securities from a corporation she owned by causing it to contribute the securities to a newly-formed subsidiary; she then distributed the securities. At the time of the transaction, the Code allowed a corporation to form a new subsidiary in a reorganization and the subsidiary to distribute its stock to the shareholder without recognizing any gain. Both the Second Circuit and the Supreme Court found that this transaction was a dividend, and not a reorganization, and disallowed nonrecognition treatment. *See* 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[125]*Elkhorn*, 95 F.2d at 734.

[126]*See supra* notes 69-88 and accompanying text.

assets by the historic target, a disguised sale, rather than a full and faithful marriage between shareholder groups.

2. *The Power of Customizing*

If *Elkhorn* had not been decided, in any event, it would have to have been invented. It is necessary to look beyond the nominal state-law target, at least in some cases, if there is to be any meaning to the substantially-all requirement. The taxpayer and the dissent in *Elkhorn* argued that the substantially-all requirement was satisfied literally in the case because the state-law corporation involved as the target transferred all of its assets in the reorganization.[127] The majority rejected the argument, because the substantially-all requirement could be defeated, under the taxpayer's interpretation, "if only the transferor will go to the slight trouble and expense of getting a new charter . . . and making the transfer of assets to the new corporation . . . ."[128] "We do not think," the court concluded, "the statutory exemption may be thus broadened by such an artifice."[129]

Absent *Elkhorn*, the substantially-all reorganization could be used by a corporation to sell any assets it wanted and qualify as a nontaxable reorganization. Assume a corporation that makes

[127] 95 F.2d at 736-37 (Watkins, J., dissenting).

[128] *Id.* at 735.

[129] *Id. See also infra* notes 228-30 and accompanying text (discussing the amendment of the pooling-of-interest rules in order to prevent selective sales).

automobiles was willing to trade a number of its automobiles for stock of some corporation that wanted to buy the fleet. Absent *Elkhorn*, the seller would just create a new subsidiary and contribute the new cars the customer wanted to the new subsidiary in exchange for subsidiary stock. The asset-acquisition reorganization would then occur with the customer using its stock to acquire the fleet of cars from the new subsidiary. The new subsidiary would transfer "substantially all its properties," but its properties would be customized to whatever the customer wanted to buy. The cars, while constituting all of the properties of the customized target, would just be some trivial fragment of the original business of the car manufacturer. The original car manufacturer would have gain, *prima facie* capital gain, deferred until the selling corporation needed to turn the voting stock into cash.[130]

The game of customized subsidiaries would be extraordinarily powerful weapon in the hands of selling corporations: one could imagine used-car dealers who sold each automobile only if each customer created some corporation that could acquire the used car for voting stock. The seller would be left holding only stock, but deferring tax on the inventory gain might well be worth the awkwardness of holding the stock as an asset. Looking beyond the

[130] *See infra* note 230 and accompanying text. There is no provision requiring that the ordinary character of the automobiles be carried over to the acquiring corporation or that the voting stock received by the target corporation in exchange for the automobiles be treated as inventory. *See, e.g.,* Acro Mfg. Co. v. Commissioner, 334 F.2d 40 (6th Cir.) (holding that a subsidiary's inventory does not remain an ordinary asset if held by the parent, even though the parent's basis is derived from that of the subsidiary), *cert. denied*, 379 U.S. 887 (1964).

nominal newly-formed target is a necessary perspective to prevent selective sales of specific assets of any kind from qualifying as reorganization. If customizing the nominal target were permitted, substantially-all-the-properties reorganizations would extend, at least for the well informed, very much beyond the whole-hearted and exclusive marriages between shareholder groups or commercial marriage that seems to be the core idea of the tax-free reorganization.[131]

Bittker and Eustice describe *Elkhorn* as intended to prevent use of the "C" reorganization for transactions that are essentially divisive in nature.[132] That description does not fit the structure of the statute very well. The *Elkhorn* transaction was the kind of division that apparently would not be considered abusive under the safeguards of modern section 355. Both the Maybeury and the non-Maybeury mines were active businesses after their separation, containing all of the operations necessary to the earning of income.[133] Moreover, the rationalization of the management operations, separating the Maybeury and non-Maybeury mines, seems to be a sufficient nontax business purpose to mean that the transaction was not a device for the disguised

[131]*See infra* Part III.B.3 (arguing that selective sales should not be treated as tax-free reorganizations).

[132]BITTKER & EUSTICE, *supra* note 105, at ¶ 12.62[3]. The substantially-all requirement in I.R.C. § 354(b)(1)(A) is designed to prevent tax-free divisions unless they pass the requirements of I.R.C. § 355. *See supra* note 111 and accompanying text.

[133]Reg. § 1.355-3(b)(2)(ii)-(iii) (defining "active conduct of a trade or business" to require "the collection of income and the payment of expenses").

distribution of dividends.[134] Under the statute in effect at the time of the *Elkhorn* transaction, such tax-free divisions could be freely accomplished.[135] Thus, the *Elkhorn* holding cannot plausibly be said to be directed at preventing a tax-free division of the historic target. The *Elkhorn* transaction, accordingly, failed not because it was a division, but because it did not comply with the substantially-all-the-properties rule. The target was attempting a selective or disguised sale of part of its business, whereas a full and faithful marriage was required.

3. *Broad View Incorporated into the Statutory Framework: 1968*

After *Elkhorn*, Congress assumed that the substantially-all-the-properties requirement would look beyond the state-law corporation that actually made the transfer. In 1968, Congress enacted section 368(a)(2)(D), authorizing "triangular mergers" in which target shareholders end up with stock, not of the fusion or marriage corporation in which their old business is conducted, but rather of a parent corporation controlling the corporation that continues the target's business.[136] Allowing triangular

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[134]Reg. § 1.355-2(d)(3)(ii) (stating that a corporate business purpose is evidence that a distribution is not a prohibited "device").

[135]*See* Revenue Act of 1924, ch 234 § 203(g), (h)(1)(B), 43 Stat. 253, 257 (allowing a corporation to form a new subsidiary and distribute the subsidiary's stock).

[136]*See* Act of Oct. 22, 1968, Pub. L. No. 90-621, 82 Stat. 1310. In 1971, Congress enacted I.R.C. § 368(a)(2)(E), allowing reverse triangular mergers, a reorganization in which the

mergers eliminated one of the remaining vestiges of the "remote continuity" objection to reorganizations: under the 1939 Code, the Supreme Court had held that target shareholders had to end up with a direct stock interest in the fusion or marriage corporation after the reorganization.[137] The Court considered ownership of the parent corporation that owns the stock of the corporation that continues the business to be too remote an interest to constitute the required continuity.[138] While Congress eliminated the remoteness objection in 1968, in a quid-pro-quo, Congress also required triangular mergers to pass the substantially-all-the-properties requirement.[139] Nontriangular

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acquiring corporation's stock is ultimately distributed to the target corporation's shareholders, and imposing the substantially-all requirement on such mergers. *See* Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077.

[137] *See* Groman v. Commissioner, 302 U.S. 82, 89 (1937).

[138] *Id. See also* Helvering v. Bashford, 302 U.S. 454, 458 (1937) (holding that a merger did not take place because the acquiring corporation placed the target corporation's historical assets into a new subsidiary). The *Bashford* version of the remoteness objection was removed by Congress in 1954 with the enactment of I.R.C. § 368(a)(2)(C). The remoteness objection for "B" and "C" reorganizations was removed by Congress in 1968 with the enactment of I.R.C. § 368(a)(1)(B), (C). The remoteness objection did not apply to "A" reorganizations provided that the target corporation was first acquired though a merger by the parent corporation and then placed into a subsidiary. *See* I.R.C. § 368(a)(2)(C).

As a result, the 1968 Act merely allowed the parent's stock to be used in a merger with a subsidiary and reduced the risk to the parent. Congress justified equal treatment among "A," "B," and "C" reorganizations by arguing that "there is no reason why tax-free treatment should be denied in cases of [remoteness] where for any reason the parent cannot or, for business or legal reasons, does not want to acquire the assets (even temporarily) through a merger." S. REP. NO. 90-1653, at 2 (1968).

[139] *See* Act of Oct. 22, 1968, Pub. L. No. 90-621, 82 Stat. 1310.

mergers, by contrast, in which target shareholders get direct continuity with stock of the fusion corporation holding the business, have no such substantially-all requirement.[140] The substantially-all requirement under section 368(a)(2)(D) is the same requirement under section 368(a)(1)(C); "substantially all" has the same meaning for triangular and "C" reorganizations.[141]

For the substantially-all-the-properties test to have any meaning in section 368(a)(2)(D), Congress had to have assumed that the test would be applied beyond the borders of the state-law corporation that actually made the transfer. Section 368(a)(2)(D) transactions are mergers of the target. In mergers, all of the assets of the disappearing target corporation will pass over to the acquirer by operation of law. If we were to look only at the disappearing target, the substantially-all requirement could never be breached--just as *Elkhorn* could never be violated if we looked only at the assets of the newly-formed corporation that literally transferred the assets. The requirement is not surplusage, however, because it incorporates the perspective, reflected by *Elkhorn*, looking beyond the borders of the nominal state-law target to see the business as a whole.

The commentary thus consistently interprets the substantially-all requirement in section 368(a)(2)(D) to include *Elkhorn*:

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[140]*See infra* notes 208-18 and accompanying text.

[141]*See* Reg. § 1.368-2(b)(2) ("The term 'substantially all' [in section 368(a)(2)(D)] has the same meaning as it has in section 368(a)(1)(C)[.]").

> In a two-party merger, premerger disposition of unwanted assets usually poses no threat to qualification under section 368(a)(1)(A). If the quantum of assets distributed is not insubstantial, a similar conclusion cannot be reached under section 368(a)(2)(D).[142]

Similarly, in 1971, Congress adopted section 368(a)(2)(E) to allow stock of a parent corporation to be used in what is called a "reverse triangular merger" acquisition.[143] Just as in 1968 for the "forward" triangular merger, so in 1971 Congress removed the remote continuity objection, and also added the substantially-all-the-properties requirement.[144] Once again, the substantially-all test was pulled over from the "C" reorganization and, again, the test has the same meaning in section 368(a)(2)(E) as it has

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[142]M. Carr Ferguson & Martin Ginsburg, *Triangular Reorganizations*, 28 TAX L. REV. 159, 178 (1973) (citations omitted). *See also* Philip C. Cook & John L. Coalson, Jr., *The "Substantially All of the Properties" Requirement in Triangular Reorganizations--A Current Review*, 35 TAX LAW. 303, 319 (1982) (arguing that the substantially-all requirement of I.R.C. § 368(a)(2)(D) is "probably most directly intended to preclude" splitting off assets that will not be sold, as in *Elkhorn*); Alan S. Kaden & Richard A. Wolfe, *Spin-offs, Split-offs, and Split-ups: A Detailed Analysis of Section 355*, 45 TAX NOTES 565, 598 n. 256 (1989) (concluding that triangular mergers are subject to *Elkhorn*).

[143]*See* Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077. In a reverse triangular merger, a subsidiary of the acquiring corporation merges into the target corporation so that the target becomes a wholly-owned subsidiary of the surviving corporation. *See* BLACK'S LAW DICTIONARY 989 (6th ed. 1990).

[144]*See* Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077.

under section 368(a)(1)(C).[145] Thus, customizing the target is prohibited before a reverse, as well as a forward, triangular merger.

4. *Look-Back Period*

To ensure that the whole of the historic business of the target passes over to the marriage, the courts will need to be able to look back in time to identify the target's historic business. Identity of the historic business has not been a problem, within the substantially-all requirement, at least once it is settled that the focus of the substantially-all test is on the operating assets of the target's business.[146] Undoubtedly, the test for identifying the historic business will remain somewhat open-ended, to be settled by the courts the way they settle all legal issues, out of the concrete facts of future adversarial proceedings. There is, however, authority for looking back three or four years, from another branch of the more general continuity-of-business doctrine, to identify the historic business. Plausibly, however, five years is the limit beyond which a look back is not permitted.

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[145] *See* Reg. § 1.368-2(j)(3)(iii) ("The term 'substantially all' has the same meaning [in section 368(a)(2)(E)] as in section 368(a)(1)(C).").

[146] *See supra* notes 71-88. The dissenting judges in *Moffatt* and *Smothers* take issue with identifying "substantially all the properties" with the operating assets of the historic business. They do not, however, take issue with identifying the historic business.

Regulation section 1.368-1(d)(2) requires the acquiring corporation to continue the target corporation's business enterprise or to use a significant part of the target's historic business assets in a business.[147] An acquisition of a target to liquidate its business, it is said, is not a reorganization if there is no continuation of the business in modified corporate form.[148] An example from the regulation illustrates the requirement with a target that had been in the business of manufacturing men's trousers three and a half years before the acquisition was consummated.[149] On January 1, 1978, the target sold the trouser business for cash and invested the cash in a diversified portfolio of investments.[150] Three and a half years

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[147] *See* Reg. § 1.368-1(d)(2). T.D. 7745, 1981-1 C.B. 134 (1980) clarifies the Regulation. Critics argue that target corporation's historical business need not be continued and that the Regulation and Treasury Decision is overly broad. *See, e.g.*, M. Bernard Aindinoff & Benjamin B. Lopata, *The Continuity of Business Enterprise Requirement and Investment Company Reorganizations*, 58 TAXES 914, 923 (1980); Gilbert D. Bloom, *The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise*, 7 J. CORP. TAX'N 315, 315 (1981); Peter L. Faber, *Continuity of Interest and Business Enterprise: Is it Time to Bury Some Sacred Cows?*, 34 TAX LAW. 239, 292 (1981).

I.R.C. § 382(c), however, endorses the continuity-of-business-enterprise requirement by terminating net operating loss carryovers if the fusion corporation does not continue the target corporation's business enterprise for at least two years. The continuity-of-business-enterprise standard derives from Reg. § 1.368-1(d). *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 318 (Comm. Print 1987).

[148] *See* Wortham Mach. Co. v. United States, 521 F.2d 160, 162-63 (10th Cir. 1975) (terminating net operating loss carryovers in a discontinued business); Hendee v. Commissioner, 98 F.2d 934, 936-37 (7th Cir. 1938) (holding that a merger was taxable because the new corporation's business was unrelated to that of the old corporation).

[149] Reg. § 1.368-1(d)(5), Ex. (3).

[150] *Id.*

later, on July 1, 1981, the target transferred the portfolio to a regulated investment company in return for stock.[151] The 1981 acquisition would not qualify as a reorganization because the historic business of the target was not continued in the acquiring corporation. The historic business of the target was not the investment portfolio, under the example, but trousers. The example looks back three and half years to identify the trouser business.[152]

Example (3) under the *-1(d)* continuity-of-business-enterprise requirement is good precedent for looking back for three to four years under the requirement that all of the operating assets of the target business must pass over in the reorganization. Both the continuity-of-business-enterprise and the shift in focus to the operating assets can be traced back to the same passage of *Cortland Specialty*: "Reorganization presupposes continuance of business under modified corporate forms."[153] The doctrines are twin siblings born in the same passage. Both doctrines look to the same historic business.[154]

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[151] *Id.*

[152] *Id.*

[153] 60 F.2d at 940. Reg. § 1.368-1(d)(2) states that the purpose of the continuity-of-business-enterprise rule is to "ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form," a paraphrase of *Cortland Specialty*.

[154] There are important differences between the continuity-of-business doctrine in Reg. § 1.368-1(d), and the substantially-all requirement. On one hand, under the continuity-of-business doctrine, large portions of the historic business may be abandoned one the business passes over, provided that the acquirer uses a significant portion of the historic business assets in a business. *See* Reg. § 1.368-1(d), Ex. (2). On the

The historic business test should plausibly be able to look back five years, but no further. Under section 355(b), the distribution of a subsidiary can be tax free, but only if after the distribution both parent and subsidiary continue the active conduct of a business that was continuously conducted by the parent for five years prior to the distribution. The requirement is a reaction to *Gregory*, in which a corporation distributed stock of a newly-formed subsidiary that contained nothing but marketable portfolio stock, and is intended as part of the bulwark by which section 355 prevents tax-free distributions from being used as a device for disguising ordinary dividends as capital gain. The requirement bears some resemblance to the historic business focus in the substantially-all test. If five years of active business is sufficient for section 355, then five years should be enough to ensure that substantially all of the target passes over in an acquisitive reorganization. Events earlier than five years before the reorganization would not define the target's historic business.[155]

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other hand, under the substantially-all requirement, large portions of historic business cannot be abandoned. This difference can be attributed to the fact that the continuity-of-business-enterprise doctrine is an anti-abuse rule added by judicial and regulatory interpretation without explicit statutory support, while the substantially-all requirement is a "super-continuity" rule explicitly applied by statute.

[155]Nevertheless, some courts have collapsed step transactions that took place over five or more years into a single, integrated transaction. *See, e.g.,* Fry v. Commissioner, 5 T.C. 1058 (1945) (liquidation of target was part of a plan of reorganization although it occurred more than six years after acquisition of the target corporation's assets); Douglas v. Commissioner, 37 B.T.A. 1122 (1938) (liquidation of target was part of a plan of reorganization although it occurred more than five years after acquisition of the target corporation's assets).

There is apparently considerable room under the Service's ruling policy, however, for taxable sales changing the target's historic business, even in preparation for the acquisition. In Revenue Ruling 88-48,[156] the Service ruled that a target could sell off unwanted assets to a third party in a taxable transaction and pass over the rest in a valid "C" reorganization, so long as the cash proceeds of the taxable sale were passed over to the acquirer.[157] There does need to be some allowance for sales by the target's business in the five years before the reorganization, but the ruling is probably too generous at the extreme. Some taxable sales in preparation for a reorganization reduce the reorganization to a cherry-picking transaction in which some assets are sold to recognize a tax loss and while others are carried into the marriage so that gain will not be recognized. Under current but questionable Service ruling policy, however, taxable sales will not prevent the historic business from passing over to the fusion so long as the proceeds of the taxable sale pass over.

B. *The Step-Transaction Doctrine*

The *Elkhorn* rule, looking beyond the borders of the nominal target to determine whether the historic business has passed over, is a branch of the step-transaction doctrine. Under the step-transaction doctrine, "the tax consequences of an

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[156] 1998-1 C.B. 117.

[157] *See supra* notes 97-112 and accompanying text.

interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan."[158] The doctrine is a subset of the general perspective that taxation depends on the substance of a transaction rather than the form.

This subpart argues that the historic business test is properly viewed as a per se rule that will look through any newly formed subsidiary that is not old and cold and will identify the historic business even if it is conducted, at the time of acquisition, in separate subsidiaries. The step-transaction doctrine is essentially a servant of tax policy, "dependent for its application on underlying considerations of substantive tax policy or Code structure,"[159] and "take[s] into account the substantive issue being addressed."[160] In the context of the substantially-all test, the doctrine needs to ensure that the reorganization resembles in some fashion a full and faithful commercial marriage and to ensure that selective sales, merely disguised as a marriage, do not qualify as tax free. Within this context, there needs to be a presumption, often irrebuttable, that newly-formed subsidiaries are transparent. Showing that the operating assets of the historic business passed over to the fusion is an affirmative prerequisite to the validity of the

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[158] Crenshaw v. United States, 450 F.2d 472, 475 (5th Cir. 1971) (citations omitted), *cert. denied,* 408 U.S. 921 (1972).

[159] Marvin A. Chirelstein & Benjamin B. Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 TAXES 970, 974 (1982).

[160] McDonald's of Zion, 432, Ill., Inc. v. Commissioner, 76 T.C. 972, 995 (1981), *rev'd*, 688 F.2d 520 (7th Cir. 1982).

reorganization. To identify the historic business of the target, separate subsidiaries often need to be transparent.

1. *Independent Economic Significance*

At one point, it looked as if the government was prepared to apply the step-transaction doctrine extraordinarily narrowly under what has been called the "independent economic significance test." Because subsidiaries almost always have independent economic significance, that test would make it almost impossible to apply the substantially-all test beyond the borders of a validly formed new state-law subsidiary. In Revenue Ruling 79-250,[161] the Service ruled that it would not collapse steps into a single overall transactions "if each step demonstrates *independent economic significance*, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes,"[162] even if the steps were made pursuant to an overall plan.

A corporation validly formed under state law almost always has independent economic significance as a matter of tax law.[163] The presumption that a duly-formed corporation has independent

[161]1979-2 C.B. 156.

[162]*Id.* at 157 (emphasis added).

[163]*See* Moline Properties v. Commissioner, 319 U.S. 436, 438-39 (1943) ("Whether the purpose be to gain an advantage under the law of the state of incorporation or avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience . . . the corporation remains a separate taxable entity[.]") (citations omitted).

significance governs.[164] Moreover, in every *Elkhorn*-like case where the target is splitting its historic business into wanted and unwanted assets, there will be some business purpose for the split, even beyond the general presumption that a corporation has a business purpose. The very reasons that made the acquiring corporation not want to acquire all of the target's business--or the reasons why the target did not want to pass over all of its historic business in the reorganization--should always give a business purpose to the splitting of the historic business into two corporations, separating the wanted and the unwanted assets. Combining the independent significance test of Revenue Ruling 79-250 with the near-certain independent significance of any state-law subsidiary, formed to hold wanted or unwanted assets, implies that the substantially-all test may never be applied beyond the state-law corporation that is nominally the target and repeals *Elkhorn*.

The Service, however, has withdrawn the broad language in Revenue Ruling 79-250 that "independent significance" will prevent the collapse of the step into a larger plan.[165] The language was probably a mistake in the first place.[166] The

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[164] *See* BITTKER & EUSTICE, *supra* note 105, at ¶ 2.07[2] (stating that recognition as a corporate entity "require[s] little if anything more than the observance of book-keeping formalities and similar nonburdensome practices").

[165] *See* Rev. Rul. 96-29, 1996-24 I.R.B. 6 (limiting the application of Rev. Rul. 79-250 to reorganizations under I.R.C. § 368(a)(1)(F)).

[166] *Service Sheds New Light on its Approach to Step Transaction Doctrine*, TAX NOTES TODAY (June 17, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 118-83) ("Rev. Rul. 79-

dominant judicial rule for testing whether steps may be collapsed is what has been called the "end result test,"[167] under which steps will be collapsed if they are "component parts of an overall plan."[168] The Treasury Department[169] has used the "over-all plan" or "end-result" test, and rejected the "independent significance" test. In addition, a revenue ruling has cited the "overall plan" to explain why steps are integrated even though the steps apparently had independent significance.[170] Courts have also integrated the formation of a new corporation into a larger transaction, even while respecting the independent significance of the new corporation.[171] Revenue Ruling 79-250 was also easily distinguished from an *Elkhorn* situation[172] and the "independent

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250 also erred in attempting to define independence too narrowly (or at all!)").

[167]*See* Stephen S. Bowen, *The End Result Test*, 72 TAXES 722, 724 (1994) ("[T]he end result test is very much the order of the day[.]"). *See also* Security Indus. Ins. Co. v. United States, 702 F.2d 1234 (5th Cir. 1983); King Enters. v. United States, 418 F.2d 511 (Cl. Ct. 1969); Penrod v. Commissioner, 88 T.C. 1415 (1987).

[168]*Crenshaw*, 450 F.2d at 475 (citations omitted).

[169]*See* T.D. 7745, 1981-1 C.B. 134.

[170]*See* Rev. Rul. 73-16, 1973-1 C.B. 186.

[171]*See* Associated Wholesale Grocers v. United States, 927 F.2d 1517, 1527 (10th Cir. 1991) ("We have found no case holding that the existence of a business purpose precludes the application of the step transaction doctrine[.]"); *Gregory*, 293 U.S. at 469 ("No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance . . . ."). *Cf.* Commissioner v. Bollinger, 485 U.S. 340, 345-46 (1988) (finding that corporation was an independent entity, even though it was merely an agent and not the tax owner of real estate).

[172]In Revenue Ruling 79-250, the corporation was attempting to accomplish three objectives: (1) transform two divisions into subsidiaries in order to limit liability; (2) acquire the

significance" test was inconsistent with the decision in *Elkhorn* itself.[173]

2. *The End or Given Result*

The dominant strand of the step-transaction doctrine is the "end result" or "given result" test, under which steps will be collapsed if they are "component parts of an overall plan."[174] Under the end or given result tests, the "individual tax significance of each step is irrelevant when, considered as a whole, they all amount to no more than a single transaction which in purpose and effect is subject to the given tax consequence."[175] Taxpayers "cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status."[176] "A

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corporation that owned the assets leased to one of the divisions; and (3) change the state of incorporation. Although these transactions occurred simultaneously, they each had an independent business purpose.

This is unlike the reorganization in *Elkhorn*, in which a customized target needed to be created before it could be acquired. The reorganization depended on the prior division of the business, even though the creation of the customized subsidiary was, in part, independently justified.

[173]Although *Elkhorn* is best understood as an "end result" case, there is language in the opinion that suggests that the taxpayer failed the independent-significance test: "A careful consideration of the evidentiary facts discloses no purpose which could have been served by the creation of the new company and the transfer of the assets to it, except to strip the old company of all of its properties . . . ." 450 F.2d at 732.

[174]*See supra* note 166 and accompanying text.

[175]*Crenshaw*, 450 F.2d at 476.

[176]*Id.* at 477.

given result at the end of a straight path is not made a different result because [it was] reached by following a devious path."[177]

Sometimes the articulation of the end or given result test emphasizes the subjective aspect of the test, as if the tax system were taxing corporate brain waves at the outset. The connections of the steps can properly be viewed from the given result, in hindsight. The intent can be presumed to have existed from the outcome. Still a *plan* is formally a subjective event. Thus the courts have described the test as collapsing a series of transactions "*intended* from the outset to be taken for the *purpose* of reaching the ultimate result"[178] or as collapsing steps "*designed* and executed as parts of a unitary *plan* to achieve an *intended* result."[179] Under the test, "the court may be called upon to determine the result the participants *hoped to achieve.*"[180]

A subjective test may be appropriate if the corporation has "left a clear and well-documented paper trail"[181] as to intent, but if the intent is hidden or the evidence ambiguous then the subjective emphasis does not make a great deal of sense. Corporations are artificial entities, which themselves have no mind. Thus, purposes or plans must be imputed to the target and

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[177]*Minnesota Tea*, 302 U.S. at 613.

[178]*King Enters.*, 418 F.2d at 518 (quoting DAVID R. HERWITZ, BUSINESS PLANNING 804 (1966)) (emphasis added).

[179]Kanawha Gas & Utils. Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954) (emphasis added).

[180]*Penrod*, 88 T.C. at 1431 (emphasis added).

[181]*Security Indus.*, 702 F.2d at 1246.

acquirer corporations from statements or actions of the principal officers or shareholders. Intents are things that happen inside of heads, and if the evidence of intent would be adverse to the corporation on taxes, one would expect the intent would be kept well inside of the head. The only evidence available will commonly be the self-serving statements of the principal officers. Still under a subjective test, the taxpayer's own characterization of the transaction may be the only evidence that is available. Where millions of dollars of tax are at stake, moreover, a taxpayer "intent," even within the mind, can be quite plastic. As Judge Easterbrook has observed, "Some people believe with great fervor preposterous things that just happen to coincide with their self-interest."[182]

Subjective tests have a history of manipulation. Resting the eligibility for a reorganization upon the primary "business purpose" or the "independent significance" for the formation of a subsidiary rubs, for instance, against the still painful wounds from the history of the subjective tests for the "multiple-surtax-exemption" abuse before 1969. Before 1969, every validly formed subsidiary or affiliated corporation was entitled to a new set of lower-than-maximum tax brackets--provided there was a primary business purpose for the new subsidiary or affiliate. Wide-spread tax planning led to the situation in which corporations formed a very large number of wholly-owned subsidiaries or affiliates to ensure that the taxable income of the group was taxed entirely in the lower corporate tax brackets.

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[182]Coleman v. Commissioner, 791 F.2d 68, 69 (7th Cir. 1986).

A sample from one study had 516 separate wholly-owned subsidiaries.[183] There was a great deal of litigation over whether the nontax business purposes were sufficient for the corporations to get the tax benefits.[184] Ultimately the litigation was terminated only by abandoning the business purpose test. In addition, the American Law Institute concluded that similarly-situated corporations should bear tax at the same corporate rate whether or not they operated best in multiple corporation form.[185]

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[183] HEARINGS BEFORE HOUSE WAYS & MEANS COMM., 91ST CONG., TAX REFORM, 5388-89 (Comm. Print 1969).

[184] *See, e.g.,* Bobsee Corp. v. United States, 411 F.2d 231 (5th Cir. 1969); Napsky v. Commissioner, 371 F.2d 189 (7th Cir. 1966); Bonneville Locks Towing Co. v. United States, 343 F.2d 790 (9th Cir. 1965); Kessmar Constr. Co. v. Commissioner, 336 F.2d 865 (9th Cir. 1964); Hawaiian Trust Co. v. United States, 291 F.2d 761 (9th Cir. 1961); James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Coastal Oil Storage Co. v. Commissioner, 242 F. 2d 396 (4th Cir. 1957); Commissioner v. Chelsea Prods., 197 F.2d 620 (2d Cir. 1952); V.H. Monette & Co. v. Commissioner, 45 T.C. 15 (1965); New England Foundry Corp. v. Commissioner, 44 T.C. 150 (1965), *acq.* 1965-2 C.B. 6; Bush Hog Mfg. Co. v. Commissioner, 42 T.C. 713 (1964); Hamburgers York Road, Inc., 41 T.C. 821 (1964); Dillier v. Commissioner, 41 T.C. 762 (1964) *aff'd sub nom.* Made Rite Inv. Co. v. Commissioner, 357 F.2d 647 (9th Cir. 1966); Cronstroms Mfg. v. Commissioner, 36 T.C. 500 (1961); Truck Terminals v. Commissioner, 33 T.C. 876 (1960), *acq.* 1960-2 C.B. 7, *aff'd in part and rev'd in part*, 314 F.2d 449 (9th Cir. 1963); Hiawatha Home Builders v. Commissioner, 36 T.C. 491 (1961); Snow-Frost, Inc. v. Commissioner, 31 T.C. 1058 (1959); Theatre Concessions v. Commissioner, 29 T.C. 754 (1958); Polak's Frutal Works v. Commissioner, 21 T.C. 953 (1954); Berland's Inc. of South Bend v. Commissioner, 16 T.C. 182 (1951); Seminole Flavor Co. v. Commissioner 4 T.C. 1215 (1945); Challenger, Inc. v. Commissioner, 23 T.C.M. (CCH) 2096, 1964 T.C.M. (RIA) ¶ 640,338; Esrenco Truck Co. v. Commissioner, 22 T.C.M. (CCH) 287, 1963 T.C.M. (RIA) ¶ 63,072; Middle States Terminals v. Commissioner, 25 T.C.M. (CCH) 203, 1966 T.C.M. (RIA) ¶ 66,032; A.G. Nelson Paper Co. v. Commissioner, 3 T.C.M. (CCH) 914, 1944 T.C.M. (RIA) ¶ 44,285.

[185] *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT: INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 375 (1958) ("[A] business which operates in multi-corporate form for reasons

In 1969, Congress eliminated the problem with a clear and administrable objective standard: subsidiary and affiliated corporations owned by a single group of shareholders have only one set of tax brackets.[186]

It is for these reasons that the courts, while giving lip service to intent, in fact "have by and large come to de-emphasize subjectivity and have either substituted more objective criteria or have relied on . . . wholly mechanical requirements . . . ."[187] Indeed, the grand pattern of the common law, according to Oliver Wendell Holmes, has been to move from subjective to objective measures:

> [W]hile the terminology of morals is still retained, and while the law does still . . . in a certain sense, measure legal liability by moral standards, it nevertheless, by the very necessity of its nature, is continually transmuting those moral standards into

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of business economy should have no tax advantage over a business which would find no particular economy in a multi-corporate arrangement[.]").

[186] *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 401(a)(1), 83 Stat. 487, 599. This Act created I.R.C. § 1561. *See also* S. REP. NO. 91-552, at 133 (1969) ("[L]arge organizations which operate through multiple corporations and which are not in reality 'small businesses' should not be allowed to receive the substantial and unintended tax benefits resulting from the multiple use of the surtax exemption and . . . other provisions[.]").

[187] Note, *State of Mind Analysis in Corporate Taxation*, 69 COLUM. L. REV. 1224, 1225-26 (1969).

> external or objective ones, from which the actual guilt of the party concerned is wholly eliminated.[188]

The Supreme Court has said that "[q]uestions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants . . . ."[189] In addition, "[s]ubjective intent cannot supply economic substance to a business transaction."[190] Or as Judge Friendly has noted, "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers."[191]

Within the step-transaction doctrine, de-emphasis of subjective or brain-wave evidence would leave outcomes as the determining factor. An outcome test can be stated as a strong presumption that the in-fact outcome was what was intended. "It is a fundamental maxim that the consequences of one's acts are presumed to be intended."[192] This is particularly true for institutional actors, which have no mind of their own and which

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[188] OLIVER WENDELL HOLMES, JR., THE COMMON LAW 38 (1881).

[189] Weiss v. Stearn, 265 U.S. 242, 254 (1924). Similarly, "the character of a reorganization proceeding . . . depends not upon the motive of the stockholders but upon 'what was done.' . . . The motive of the stockholders is immaterial, if a reorganization of the corporate business is in fact accomplished." Survaunt v. Commissioner, 162 F.2d 753, 757 (8th Cir. 1947).

[190] Peat Oil & Gas Assocs. v. Commissioner, 100 T.C. 271, 287 (1993) (Ruwe, J., concurring); Cherin v. Commissioner, 89 T.C. 986, 994 (1987).

[191] *Lynch*, 273 F.2d at 872.

[192] Fox v. Commissioner, 82 T.C. 1001, 1022 (1984).

frequently reach decisions as "the product of compromise, of collective decisionmaking, and of mixed motivation."[193] A court should determine the most important meaning of a new subsidiary with perfect hindsight, after the results of the transaction are in. Second steps, once taken, would be allowed to reveal that "the ultimate result was intended from the outset."[194] If, for instance, in hindsight it can be seen that the most important use of a new subsidiary was to separate the wanted from the unwanted assets of a unified business and to convey to the acquirer only the wanted assets, then the subsidiary would become transparent and the courts would be able to see that not all of the historic business passed over. The proof of the intended use of the subsidiary should be in the use to which it was in fact put. If the acquirer picked up only part of the assets of the historic corporation, that is, those found in the newly formed subsidiary, that would be treated not as an accident irrelevant to the transaction. It would instead be presumed that the subsidiary was customized to serve its actual function of conveying assets over to the acquirer.

Under this strong presumption, it would not be sufficient to rely on the general presumption that all corporations have a business purpose. It would not be sufficient to point to vague future plans that never came about or risks or worries that never materialized. Only actual uses seen after the fact would count.

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[193]Washington v. Davis, 426 U.S. 229, 253 (Stevens, J., concurring) (describing government action).

[194]*King Enters.*, 418 F.2d at 518.

While the new subsidiary would be treated as real for both tax and nontax purposes, the new subsidiary would just not define the field of focus or inquiry to apply the historic business requirement. Only if the new subsidiary was actually used for a purpose more important than the tax at stake in the reorganization would the subsidiary be allowed to narrow the focus of the historic business test.

3. *Old and Cold*

The step-transaction doctrine also has a "per se" or "irrebuttable presumption" variation, captured by the tax jargon expression of "old and cold" in which there is no room for subjective inquiry as to the target's purposes in splitting its historic business. "Old and cold" steps cannot be collapsed into the greater transaction, but steps that are "young and warm" will be collapsed.[195] In a "B" reorganization, for example, the acquiring group must use "solely voting stock" of the group and must end up with eighty percent of the stock of the target.[196] As a result, acquiring some of the stock of the target for cash should not cause failure of the solely-for-voting-stock requirement if the cash acquisition was in a separate transaction--if the cash acquisition was "old and cold" when the

[195] *See Corporate Acquisitions*, *in* CORPORATE TAX REFORM: A REPORT OF THE INVITATIONAL CONFERENCE ON SUBCHAPTER C 123-24 (American Bar Ass'n 1988). *See also* Charles C. MacLean, *Creeping Acquisitions*, 21 TAX L. REV. 345, 353 (1966) (describing an "old and cold" transaction).

[196] *See* I.R.C. § 368(a)(1)(B), (C).

reorganization acquisition was undertaken. The eighty percent control requirement is the analog, in the "B" reorganization, to the substantially-all-the-properties requirement in the asset acquisitions. Both attempt to distinguish disguised sales from whole-hearted corporate marriages; what is "old and cold" for one test should be "old and cold" for the other.

Professor Walter Blum has suggested that the old-and-cold rule in the "B" reorganization should be a purely mechanical rule, looking back two years.[197] Professor Blum would require that in all reorganizations, not just in "B" reorganizations, the acquiring corporation must acquire eighty percent of the target corporation using its own stock.[198] All acquisitions of target stock within the last two years would be aggregated to ascertain whether the eighty percent of the target was acquired with the acquirer's stock.[199] Thus, for example, a purchase of twenty-five percent of the target's stock by the acquiring corporation would be ignored if it occurred three years before the reorganization, but it would destroy the qualification of the reorganization if it occurred within two years.[200]

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[197]Walter J. Blum, *Corporate Acquisitions Under the Income Tax: Another Approach*, 50 TAXES 85, 90 (1972). Professor Blum advocates mechanical rules in many situations in order to avoid determining tax consequences using subjective tests.

[198]*Id.* at 91.

[199]*Id.*

[200]*Id.* at 90-91.

Accounting standards also supports a two year per se look-back.[201] Accounting, like tax law, attempts to prevent selective sales of part of the assets of a target from qualifying for nonrecognition. As a result, a merger would fail as a reorganization or "pooling" under accounting theory unless there is a transfer of all the assets and operations, determined by looking back two years before the merger. By requiring that the target must have been an independent corporation or corporate group for the last two years before the acquisition was initiated, accounting pooling prohibits customizing a target within two years of the acquisition, without inquiry into motive for the formation of the new subsidiary.[202]

There is also a working rule of thumb that incorporations are not old and cold and will be ignored per se if they occur within a year of the transfer to the acquiring corporation. Waiting for more than year end is not a safe harbor, but going forward within the same year is certainly an invitation for disaster.[203] At a minimum, as the time gap between the separation

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[201]*See Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at 46 (One of the "essential attributes of combining companies" is that each "has not been a subsidiary or division of another corporation within two years before the plan of combination[.]").

[202]*See infra* note 229 and accompanying text.

[203]*See* Reg. § 1.368-2(c) ("a series of transactions taking place over a relatively short period of time such as 12 months" is considered a single transaction); Jack S. Levin & Stephen S. Bowen, *Taxable and Tax-Free Two-Step Acquisitions and Minority Sqeezeouts*, 33 TAX L. REV. 425, 429 (1978) ("a holding period of only 12 months is not sufficient to make stock old and cold").

and the reorganization grows shorter, the intensity of the presumption of single transaction grows stronger.

A rebuttable presumption, represented for instance by a hindsight test would shade into an irrebuttable presumption, represented for instance by a two-year "old and cold" test, as more and more strength is required of the taxpayer's demonstrated purpose for the separation of the original business. The shorter the distance between the separation of the historic business and the acquisition, the stronger the explanation would have to be that there is a separate purpose.[204]

Irrebuttable presumptions are probably better law. An irrebuttable presumption is more administrable.[205] No litigation would be needed over the separate purposes. In addition an irrebuttable presumption would also prevent distractions: two target corporations that each split its business and then went into a "C" reorganization with one fragment should both fail the substantially-all test because of the outcome of the transaction, even if one corporation had an innocent purpose and the other had a guilty purpose for forming the new corporation. In the end, the

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[204] *Cf.* Reg. § 1.355-2(d)(3)(ii) ("The stronger the evidence of device . . . the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device[.]").

[205] *Cf.* James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 473-74, 481-82, 486 (explaining that, in the context of minority discounts by the estate and gift taxes, an irrebuttable presumption would be easier to administrate than a rebuttable presumption).

tax is not a tax on brain waves and the differing brain waves between the two corporations should not be allowed to count.[206]

IV. POLICY FOR THE FUTURE: CONSISTENT APPLICATION OF *ELKHORN*

Under current law, the substantially-all-the-properties requirement applies to some kinds of tax-free reorganizations, but not to others. Asset-acquisition or "C" reorganizations and triangular mergers, forward and reverse,[207] have a substantially-all requirement. Mergers or "A" reorganizations, and stock acquisitions or "B" reorganizations, have no substantially-all requirement and thus they can be accomplished without passing over the historic business.[208] Applying the substantially-all requirement to some reorganizations but not to others makes no sense; the requirement should either be applied to all reorganizations or to none. This Part concludes that the disparity needs to be ended legislatively by preventing the customization of a target and the selective sales of assets in all tax-free reorganizations; that is, by extending the substantially-all-the-properties requirement to nontriangular mergers and to stock acquisitions.

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[206] *Cf.* AMERICAN LAW INSTITUTE, *supra* note 185, at 375 ("[T]here exists considerable uncertainty, caused largely by the use of the subjective "avoidance" test . . . . Such uncertainty would appear to make it difficult for taxpayers to know what they can and cannot do in respect of multiple corporations[.]").

[207] *See* I.R.C. § 368(a)(2)(D), (E). *See also supra* notes 135-44 and accompanying text.

[208] *See* I.R.C. § 368(a)(1)(A), (B).

A. *Permitted Acquisitions of Business Fragments in "A" and "B" Reorganizations*

In "B" and nontriangular "A" reorganizations, the Service has ruled, all of the historic business of the target need not pass over into the fusion or marriage corporation. The historic business may be separated by a tax-free spin off qualifying under section 355 and the separation of the business into wanted and unwanted fragments of the original business will not prevent the qualification of an acquisition of the corporation that holds the wanted assets.

1. *Preparatory Fissions in a "B" Reorganization*

In Revenue Ruling 70-434,[209] the Service allowed the target to slough off unwanted assets in preparation for a "B" reorganization. In the ruling, the target corporation ran both a toy manufacturing business and a hand-tool manufacturing business. The acquiring corporation wanted to acquire only the hand-tool business, not the toy business.[210] In reaction, the target contributed the toy business to a newly-formed subsidiary and distributed the stock of subsidiary as a pro rata dividend to its shareholders. The acquirer then acquired the target corporation, shorn of its toys and containing only the tool

[209] 1970-2 C.B. 83.

[210] *Id.*

business.[211] The Service ruled that the dividend was a tax-free distribution under section 355 and that the acquisition of the target, custom-shrunk for the purposes of the reorganization, qualified as a tax-free "B" or stock acquisition.[212]

The reorganization in Revenue Ruling 70-434 could not have qualified as a "C" or triangular merger under any version of *Elkhorn* because substantially all of the historic target did not pass over. The spin off of the unwanted toys was part of an integrated plan to customize the target, and while some purpose might have been found for incorporating and separating the toys, the ruling assumes the steps were collapsed. Still the slough off of unwanted assets was ruled not to be incompatible with the "B" reorganization.

The "B" reorganization has its own requirement that the acquiring corporation end up with control of eighty percent of the stock of the target. This requirement is parallel to the substantially-all-the-properties requirement in the "C" reorganization in that it makes the stock sale look a bit more like a commercial marriage. In the ruling, the acquirer took all of the stock of the target shareholders. Drafters of the statute might have fairly assumed that an acquirer who got all the stock would acquire all the target business. The eighty percent control-of-stock requirement in the "B", however, is not the same as the substantially-all-the-properties requirement in the "C." The pro rata distribution of the toy subsidiary changed none of

[211] *Id.*

[212] *Id.*

the shareholders' interests in the ongoing tool corporation and all of the historic shareholders of the target passed over to the acquirer. The fact that not all the operating assets historic businesses passed over did not matter.

2. *Preparatory Fissions in an "A" Reorganization*

The Service has also allowed customizing the target in preparation for a nontriangular merger. In Revenue Ruling 75-406,[213] one corporation, X, distributed all of the stock of a subsidiary, pro rata as a dividend to shareholders, "[i]n order to comply with an order of a governmental agency requiring X to divest itself of any interest in [the subsidiary] . . . ."[214] "Soon"[215] after the distribution, the shareholders received and approved a management plan to merge the former subsidiary just received into an unrelated acquirer under a nontriangular "A" merger.[216] The Service ruled that the dividend qualified as a tax-free section 355 distribution and that the acquisition qualified as a tax-free nontriangular merger.[217] The shareholders of X remained indirect owners of the subsidiary's business after the merger, the ruling explained. Thus, the exchange soon after the distribution did not violate the continuity-of-interest rules

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[213] 1975-2 C.B. 125.

[214] 1975-2 C.B. at 125.

[215] *Id.*

[216] *Id.*

[217] *Id.*

either for section 355 or for mergers.[218] The transaction in Revenue Ruling 75-406 could not have qualified as a "C" or a triangular merger reorganization, because substantially all of properties did not pass over. Still, the "A" reorganization, like the "B" reorganization, has no substantially-all-the-properties requirement.

Both Revenue Ruling 70-434 (the "B" reorganization) and Revenue Ruling 75-406 (the nontriangular "A") happened to have involved a section 355 distribution sloughing off the unwanted assets or separating the wanted assets to be acquired. Because of section 355, the unwanted assets and wanted assets both had to constitute an active trade or business after they were separated from the historical target;[219] before the separation, the unwanted assets had to have been part of a business actively conducted for over five years.[220] Because of section 355, any distribution could

[218]Revenue Ruling 75-406 is ambiguous because it might be considered to involve a step-transaction situation, and impose a strict rule concerning collapsing steps. In the ruling, a government agency required the section 355 distribution, a qualifying purpose. *See* Reg. § 1.355(b)(5), Ex. 1 (distribution pursuant to a divesture order resulting from antitrust litigation has a valid business purpose).

The Service held that the ownership of the former subsidiary was real and meaningful because shareholders could vote for or against the merger. *See* 1975-2 C.B. at 125. *But see* Rev. Rul. 96-30, 1996-24 I.R.B. 4 (shareholder vote will not necessarily prevent collapse of steps).

Nevertheless, the facts of Revenue Ruling 75-406 do not eliminate the possibility that the spin-off and merger might have been part of an integrated plan to increase shareholder wealth, a motivation which would have been sufficient to collapse the steps. *See supra* notes 167-79 and accompanying text.

[219]*See* I.R.C. § 355(b)(1)(A).

[220]*See* I.R.C. § 355(b)(2)(B).

have been a device to circumvent ordinary dividend taxation.[221] Nonetheless, the rulings did not depend upon the separation of wanted from unwanted assets qualifying as a section 355 distribution. The rulings seem to support the segregation of wanted from unwanted assets, even though one or the other is merely a fragment of a business or appreciated assets. A corporation with appreciated assets that it wanted to dispose of tax-free could dispose of those assets at least in return for corporate stock, simply by (1) putting the assets into a new subsidiary and (2) exchanging the stock of the new subsidiary for acquirer stock. The selling corporation would have to be satisfied with stock of the acquirer. If some minimal purpose could be found for the formation of the new subsidiary--and validly formed corporations always benefit from a strong presumption that they have a business purpose--then the acquisition would seem to be separate, under the standards of Revenue Rulings 70-434 and 75-406, and the reorganization could qualify as tax free, so long as there was no requirement that the entire historic business pass over to the merger.

B. *How to Eliminate the Disparity?*

The statute, on its face and by congressional intent, has the disparity of requiring "substantially all" for some reorganizations, but not for others. The disparity is hard to defend, however, as a matter of policy. If the rule is of one of

[221] *See* I.R.C. § 355(a)(1)(B).

fundamental principle, why does not it apply to all reorganizations? If the rule is trivial or perverse, why apply it to any?

The availability of the "B" or the nontriangular "A" reorganization to make a tax-free acquisition renders the substantially-all requirement an avoidable rule. There are business conveniences to the "C" and the triangular "A" reorganizations, which carry the substantially-all requirement,[222] but, where material amounts of tax are at stake, the conveniences may not be worth the cost of paying tax. Well-advised taxpayers will then exchange the conveniences of the "C" or triangular reorganization for tax-free treatment even when the acquirer wants selected assets and does not want to acquire all of the target's historic business. The availability of a shunt around the substantially-all requirement with a "B" or nontriangular merger means that the historic business requirement is part of the "lacy filigree"[223] of reorganization law, full of sound and fury but not enforceable when the tax at stake is large enough to matter. Ultimately the disparate treatment needs to be fixed, either by imposing a substantially-all test on all reorganizations or on none.

There have been two proposals to restate the corporate acquisitions rules, both by well-respected institutions, which would end the disparity and rationalize acquisitions rules. One

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[222] *See supra* note 115.

[223] Ernest J. Brown, *An Approach to Subchapter C*, 3 TAX REVISION COMPENDIUM: COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1619 (Comm. Print 1959).

restatement, however, would end the disparity by imposing prohibitions on customizing the target in reorganizations of all kinds, including the stock acquisition and nontriangular merger. The other restatement, on the opposite tack, would end the disparity by repealing *Elkhorn* and anti-customizing rules, even for the "C" and triangular "A" reorganization.

1. *APB Opinion No. 16*

In 1970, the Accounting Principles Board rewrote the rules of financial accounting for eligibility for the "pooling method" of accounting for corporate acquisitions purposes to prevent customizing the target within two years before an acquisition.[224] The pooling method of accounting for corporate acquisitions is the nontax analog of the tax-free reorganizations and draws ideas from the tax law concept of the reorganization.[225] Under the

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[224]*See Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 46.

[225]*See supra* note 52 and accompanying text. In a pooling of interest, the target corporation's earnings and asset accounts are carried over into the acquiring corporation; similarly in a tax-free reorganization, the target corporation's earnings and profits, and basis are carried over into the acquiring corporation. *Compare Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 51 *with* I.R.C. §§ 381, 362(b).

For tax purposes, the most important benefit of a tax-free reorganization is the nonrecognition of gain for the target and its shareholders; however, this is usually not a material issue in financial accounting. Financial accounting serves outside investors who have or might buy stock or bonds in the reporting corporation--in the acquisition, the target corporation dissolves and is, therefore, unavailable as an investment. Even in acquisitions accounted as purchases, the target corporation cannot report gain from the acquiring corporation's stock that is used in the acquiring corporation's consolidated earnings because pooling method, the acquiring corporation does not have to recognize its acquisition of the target as a cost and thus neither increases the asset accounts of the target to current value nor increases depreciation expenses for future years.[226] Prior to 1970, the accounting standards, drawing on the tax doctrine of continuity of interest, made an acquisition eligible for the pooling method if substantially all of the ownership interests in the constituent corporations become owners of the fusion corporation.[227] The earlier rule was criticized for making it too easy to accomplish nonrecognition and to "purchase earnings,"[228] and, in 1970, tougher standards were adopted.

The 1970 standard tightened the rules to prevent the pooling method from being used for acquisitions of "only selected assets,

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it would create earnings for the acquiring corporation that are based on the use of its own stock.

Another important issue in financial accounting is determining if the acquiring corporation must report dramatically larger depreciation or amortization expenses following the acquisition because it must recognize the acquisition as a cost. Under the pooling of interests method, the acquisition is not a cost and the asset accounts of the target corporation carry over as depreciable assets for the acquiring corporation. *See Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 51. Under the purchase method, however, the acquiring corporation must treat the stock it issues as a cost equal to the fair market value of target corporation's assets. *See Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 67.

[226] *See Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 51.

[227] *See Business Combinations*, Accounting Research Bulletin No. 48, *supra* note 52, at ¶¶ 1, 4. *See also supra* note 52 and accompanying text.

[228] *See* Abraham J. Briloff, *Accounting Practices and the Merger Movement*, 45 Notre Dame L. Rev. 604, 620-21 (1970).

operations, or ownership interests" of the target.[229] In acquisitions eligible for the pooling method, "each of the combining companies [must have been] autonomous and [must not have] been a subsidiary or division of another corporation within two years before the plan of combination is initiated."[230] Thus, all the members of a controlled or affiliated group of corporations must join into the combination. If one of the corporations was formed within the prior two years, it must not have been a part of a company, division, or business that has joined neither the combination nor a successor to such business within the prior two years.

The requirement that all of an affiliated group of corporations must join in the marriage eligible for pooling was explained as preventing nonrecognition in sales of selected assets:

> You can readily imagine that if the only criterion the Board had established was an exchange of voting common stock, then if manufacturing Company A had a machine shop that it wanted to dispose of, it could incorporate it in Delaware for $150 in legal expense, and then exchange the voting stock of this newly established subsidiary for voting common stock of Company B,

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[229] *Business Combinations,* Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 46.

[230] *Id.* This requirement contains only one exception, allowing a "[d]ivesture of assets to comply with an order of a governmental authority or judicial body . . . ." *Id.*

> thereby qualifying the transaction as a pooling of interests.
>
> So in effect A's machine shop would have moved over to entity B.
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> . . .
>
> A and B would not have combined, even though there was an exchange of common stock . . . .[231]

More generally, the standard looks at a corporate group as if it were only a single corporation. There is no distinction drawn between doing business with divisions and subsidiaries, and no distinction between pre-existing subsidiaries and subsidies created in preparation for transfer.

Accordingly, under the accounting standards now in effect, *Elkhorn* is applied with an automatic two-year look-back rule for all reorganizations including the nontriangular "A" and the "B". Changes beyond two years are ignored, but there can be no customizing of the target within two years, regardless of the subjective intent of the parties.[232] Accounting standards are not precedent as to how to interpret tax law, and tax and nontax

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[231] AMERICAN BAR ASS'N SECTION OF TAXATION, *Accounting Principles for Pooling of Interests: Panel Discussion Sponsored by the Section of Taxation*, 25 TAX LAW. 29, 32 (1971) (statement of George C. Watt). *See also Corporate Acquisitions*, *supra* note 195, at 123 (statement of David H. Brockway, Chief of Staff, Joint Committee on Taxation).

[232] The target corporation may not be customized by redeeming out some of its ownership interests in preparation for acquisition. Substantially all of the target corporation's shareholders must come over to the acquiring corporation. *See Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52, at ¶ 47.

accounting often serve different purposes. Nonetheless a nontax "pooling" is a close analog of a tax "reorganization" and the accounting redefinition is thoughtful and persuasive.

2. *ALI Subchapter C Project*

By contrast, a 1982 proposal by the American Law Institute would have repealed *Elkhorn* for all reorganizations.[233] Under the 1982 proposal, parties would be allowed to customize the nominal target in preparation for a tax-free acquisition. Distribution or sale of target assets immediately before the acquisition could not defeat the tax-free treatment and a historic target could form a new subsidiary with assets solely for the purpose of having it be acquired.

The proposed repeal of *Elkhorn* relied in part on the ability to avoid *Elkhorn* with a "B" or nontriangular "A":

> [T]he statute requires an asset acquisition to embrace "substantially all of the properties" of an acquired corporation. That provision has been interpreted not to allow a spin-off of unwanted assets prior to an asset acquisition. There appears to be little substantive

[233] FEDERAL INCOME TAX PROJECT: SUBCHAPTER C 169 (American Law Inst. 1982). "Substantially all of the properties" would be defined as "substantially all of the properties immediately prior to an acquisition, without regard to other properties that may have been distributed or otherwise disposed of in preparation for the acquisition). *Id.* at 168. *See generally* Bernard Wolfman, *"Continuity of Interest" and the American Law Institute Study*, 57 TAXES 840 (1979).

> reason for this restrictive interpretation, and a merger or a stock acquisition is permitted to proceed taxfree even immediately after a preparatory spin-off.
>
> . . . .
>
> There does not appear to be any persuasive reason for preserving any of these special limitations and conditions for nontaxability of acquisition stock exchanges.[234]

The ALI proposal called, more generally, for making nonrecognition easily available to taxpayers by mere election. The call for repeal of *Elkhorn* is driven not so much by a specific critique of *Elkhorn* or the full-and-faithful marriage ideal as it is by the more general idea of expanding nonrecognition. The ALI proposal also would repeal most of the other definitional restrictions on reorganizations, including the continuity-of-interest doctrine and the voting-stock requirements.

Easy nonrecognition at the corporation level was justified primarily by the easy availability of taxable stock purchases.[235] A corporation can always avoid recognition of gain on the

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[234] FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, *supra* note 233, at 166-167 (citations omitted).

[235] *Id.* at 72 (stating that corporate-level elective nonrecognition arises from the prototypical simple sale of stock). A taxable sale of stock requires target shareholders to pay tax immediately on the appreciation of their stock, while a reorganization does not. As a result, if shareholder gain is considerable, as it often is, then a taxable sale of stock is not a suitable alternative to a tax-free reorganization.

corporate level in a corporate acquisition if the acquirer bought stock of the target rather than its assets. A taxable purchase of target shares requires the shareholders of the target to pay immediate tax on the appreciation of their stock. The stock purchase also leaves the new owners with a carryover, presumably low, basis in the business assets at the corporate level of their newly acquired business and the successor to the assets would have a low basis when the assets are sold or depreciated. Still, if the parties were willing to pay the price of shareholder tax and carryover basis, then corporate-level nonrecognition would always be available by election by acquiring the corporation by buying its stock. Since taxable sales are freely available, the ALI proposal assumes that nonrecognition should be freely available at the corporate level, if the parties will pay shareholder tax and carry over the basis of corporate assets.[236]

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[236]*Id.* at 165-66. The ALI proposal would permit even selective sales of corporate assets to qualify for nonrecognition treatment, provided that the target corporation's shareholders recognized gain and the acquiring corporation kept the pre-reorganization basis. The target corporation could place the selected assets into a newly-formed subsidiary and sell the stock of the subsidiary to the acquiring corporation. The target corporation would have to distribute the consideration it received and the target shareholders would be taxed on that consideration, regardless of its form. The acquiring corporation would have the same basis in the assets as the original target corporation had. Shareholders, but not the corporation, would be taxed. *See id.* at 96-97.

In addition, the ALI proposal would allow nonrecognition even if the selected assets were not a "major portion" of the target corporation's total assets and even if the consideration received was not distributed, provided that the consideration was the acquiring corporation's stock. *See id.* As a result, the ALI proposal would reduce the disparate treatment between pre-existing and customized target corporations.

The ALI proposal finally operated within a larger traditional argument that realized gain should not be taxed if it were reinvested and maintained in a corporate form.[237] The reorganization provisions are said to serve the function traditionally served by the nontaxation of capital gains.[238] Any substantive limitation on the tax-free acquisition, the reporter argued, cannot be reconciled with the general availability of the nonrealization even when a shareholder's investment changes dramatically. "[W]e also take it as given that mere appreciation in the value of corporate shares is not taxable even when there has been a rather complete change in the business or assets represented by those shares, or in the marketability of those shares themselves."[239] While one might assert a rule that any substantial change in the shareholder's position would normally be taxable, the reporter reasoned, "[o]ne might as well begin by asserting that the general rule for shareholders is that they are not individually taxed on their gains so long as those gains remain in corporate solution . . . ."[240]

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[237]Some scholars have advocated "rollover" provisions--tax-free treatment of cash received in a reorganization that is reinvested. *See, e.g.,* Cynthia Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 TAX L. REV. 385 (1986); Reuben Clark, *The Paradox of Capital Gains: Taxable Income That Ought not to be Currently Taxed*, 2 TAX REVISION COMPENDIUM: COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1243 (Comm. Print 1959). *See also* Kornhauser, *supra* note 23, at 861-62 (discussing the "tax benefit rule," which states that reinvested capital should not be taxed).

[238]*See* Brown, *supra* note 223, at 1621-22.

[239]FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, *supra* note 233, at 162.

[240]*Id.*

3. *Shrinking the Tax Base Is Not Justified*

The Accounting Principles Board perspective would modestly contract the tax-free reorganization, curtailing customization of the target, whereas the American Law Institute perspective would expand the tax reorganization to allow a selective sale of corporate assets. On this issue, the APB seems wiser than the ALI. A rule that expands the tax base is ordinarily to be preferred to a rule that so dramatically expands the nature of the reorganization. A strong and wide tax base is what keeps the tax rates down. The tax-free reorganization does not need to be expanded, on its economic merits, beyond the full and faithful marriage.

Notwithstanding the ALI's statement that "[t]here appears to be little substantive reason for [*Elkhorn's*] restrictive interpretation,"[241] the anti-customizing rules of *Elkhorn* and APB Opinion No. 16 are quite defensible within the traditional understanding of the reorganization provisions and within the confines of our realization income tax. The reorganization traditionally has been restricted to a fusion or marriage between two shareholder groups that is somewhat akin to a full and faithful commercial marriage. It is not supposed to cover selective or disguised sales of assets. Expanding nonrecognition to cover selective sales of assets, including for instance

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[241] *Id.*

inventory, would change the qualitative meaning of the reorganization.[242]

The heart of *Elkhorn* is to look beyond the borders of a state-law subsidiary formed or customized to transfer part of the business assets. The 1970 accounting standard goes beyond *Elkhorn* to treat both pre-existing and custom-formed or tailored subsidiaries as part of the same target business. APB Opinion No. 16 prohibits nonrecognition pooling for a corporation that was a subsidiary or division of another corporation within the prior two years.[243] The opinion does seem wise in insisting on "full consolidation," that is, in treating the subsidiary as if it were just an unincorporated subpart of the target corporation. There is no viable economic distinction between a wholly-owned subsidiary of a corporation and a division or subdivision within a single corporation,[244] so much so that it is surprising that in 1982 the ALI was willing to respect the borders of a separate subsidiary in its reworking of the framework.

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[242]The ALI proposal recognizes this potential change by restricting the creation of customized subsidiaries. It requires that the customized subsidiary be given a "major portion" of the target corporation's assets. *Id.* at 97. This discourages "excessive fine tuning." *Id.* at 98. Indeed, the "major portion" requirement prevents selective sales, just as does the substantially-all requirement.

The ALI proposal has a more flexible approach concerning pre-existing subsidiaries; however, there is no justification for this disparate treatment. *See infra* note 245 and accompanying text.

[243]*See supra* note 229 and accompanying text.

[244]*See supra* note 184 and accompanying text. *See also* Corporate Acquisitions, *supra* note 195, at 121-22 (discussing selective transfers).

Once a full consolidation approach is taken, there is no reason why the ALI's like-a-stock-sale argument implies a repeal of the requirement that the full historic business must pass over into the fusion. APB Opinion No. 16 requires that virtually all of the stock of the target must pass over into the fusion. Acquisition of virtually all of the stock of the historic group would ordinarily be tantamount to acquisition of the historic business. Even beyond the full consolidation approach, moreover, a stock purchase is hardly a justification for selective sales of a small fraction of the corporate assets because under the corporate form, acquisition of less than voting control of shares does not accomplish acquisition of any assets.

The ALI proposal also cites the availability of taxable stock sales as a reason not to tax the corporation[245] and the availability of radical and taxable asset make-overs as a reason not to tax the shareholder.[246] But a taxable stock sale requires tax at the shareholder level and a taxable asset sale requires tax at the corporate level, so that the taxable sale does require tax to paid at one level or the other. The arguments, even when combined, do not justify tax at neither the corporate nor shareholder level. Within the confines of the reorganization as we now know it, however, there is no way to maintain shareholder tax upon a corporate acquisition, as in a taxable sale of stock, while granting nonrecognition of the corporate gain under the

[245]*See* FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, *supra* note 233, at 72. *See also supra* note 234.

[246]*See supra* note 239 and accompanying text.

reorganization definitions and no way to maintain corporate tax while giving corporate level nonrecognition. A reorganization, if it is eligible, qualifies as a tax-free event on both the corporate and shareholder levels.[247] Under the current framework, a selective sale will pick up neither shareholder nor corporate tax if the transaction is defined as a reorganization.

On the shareholder level, there are few good policy reasons for expanding the scope of the reorganization. A reorganization is a realization event, under any constitutional or common-sense meaning of realization.[248] A corporate acquisition is a bargained-for exchange in which transferors receive valuable, usually marketable property, whose value is set by the bargaining, commonly down to the nearest dollar. As the APB put it:

> [A] business combination is a significant economic event which results from bargaining between independent parties. Each party bargains on the basis of his assessment of the current status and future prospects of each constituent as a separate enterprise and as a

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[247] *See* I.R.C. §§ 354(a)(1), 361(a).

[248] As Professor Blum noted:

> In handling the shareholder issues, we are at once confronted with the salient fact that under our law an investment swap is generally regarded as an event for recognizing whatever gain or loss the investor has experienced. From the viewpoint of achieving equity among taxpayers, an observer is hard put to explain persuasively why an investment swap connected with a corporate acquisition should attract vastly different--and usually much more favorable--treatment than ordinary trades undertaken to reposition an investment portfolio.

Blum, *supra* note 197, at 86.

> contributor to the proposed combined enterprise. The agreed terms of combination recognize primarily the bargained values . . . .[249]

The ALI proposal also seems to assume, erroneously, that withdrawals of capital from the corporate solution will be taxed to the shareholders when and if the withdrawals occur. Within the confines of the current system, however, stepping up basis at death, most shareholder gain not taxed in the reorganization escapes tax in full. In a reorganization, the shareholder's basis in target shares carries over to the fusion or acquiring corporate shares received back in the exchange,[250] so that the built-in gain might be taxed in theory. The tax paid on the shareholder's built-in gain is, however, mostly virtual tax. Something on the order of seventy-five to ninety percent of the tax on unrealized capital gains is never collected.[251] Gain property is usually held until death and disappears on death with the step-up in basis for the overwhelmingly largest fraction of tax involved.[252] Heirs can then sell and consume the gain without tax. What sales are made during life are mostly offset by capital losses or involve insubstantial amounts of tax. If the tax system

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[249] *Business Combinations*, Accounting Principles Board Opinion No. 16, *supra* note 52 at ¶ 19.

[250] *See* I.R.C. § 358(b)(2).

[251] *See* Jane G. Gravelle & Lawrence B. Lindsey, *Capital Gains*, 38 TAX NOTES (TA) 397, 400 (Jan. 25, 1988); Calvin H. Johnson, *The Undertaxation of Holding Gains*, 55 TAX NOTES (TA) 807, 812 (May 11, 1992).

[252] *See* I.R.C. § 1014(a).

is thus to reach withdrawals and consumption of capital from the corporate solution, accordingly, it must do so back at the corporate acquisition. A realization income tax cannot lightly afford to give up tax on realization events, because it cannot effectively collect tax on consumed amounts in any other way.

Any shareholder taxed upon a corporate acquisition is not unfairly taxed, he or she is simply returned to the more general norms for taxation of investment capital under an income tax. Under an income tax, investments are made and continued with post-tax capital. Within the general norms of an income tax, it would be equitable to tax the bargained-for exchange that occurs in a merger in order to raise shareholders' tax basis to describe more accurately their real investment. Permanent exemption for unrealized appreciation is not consistent with the norms of an income tax, even if there is also carryover basis.[253]

If tax on capital is to be reduced, moreover, unrealized appreciation is not the best place to give the reduction. Unrealized appreciation is already relatively undertaxed.[254] Reducing the tax on capital would be better-focused on dividends and even on realized rents and interest, which are relatively highly-taxed items. Budgeted subsidies to encourage capital formation should ordinarily be focused on new savings and especially targeted to the marginal savings that would not occur

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[253] *See* Corporate Acquisitions, *supra* note 195, at 81-127 (statement of David H. Brockway, Chief of Staff, Joint Committee on Taxation) (arguing that carryover basis rules are not consistent with an income tax).

[254] *See* Johnson, *supra* note 252, at 816.

without the subsidy, and even more focused on the kinds of savings in which the social return will be greater than their cost. As a matter of engineering, it would be better to direct tax incentives toward new savings and new wealth, where there is some possibility of inducing a response, rather than to old wealth formed in the past and so beyond inducement. Subsidies devoted to unrealized appreciation are devoted to savings that has occurred already and that is a waste of the cost.

The argument for liberalizing the tax-free reorganization to forgo tax revenue also has to depend upon the definition of the base line or norm because a corporate acquisition is not a likely or worthy target of special subsidy. The case for subsidizing corporate acquisitions is mixed at best. While nonrecognition of tax may sometimes remove restrictions which impede the flow of capital in a dynamic economy,[255] nonrecognition may also promote undue economic concentration.[256] Some reorganizations may both promote undue economic concentration and impede the flow of capital depending upon the eye of the beholder. Congress has not generally shown favoritism for the corporate acquisition; there is in fact a tendency in Congress to define the problem as one of discouraging corporate acquisitions so as to preserve local

[255] *See* John Dane, Jr., *The Case for Nonrecognition of Gain in Reorganization Exchanges*, 36 TAXES 244, 249 (1958).

[256] *See, e.g.,* Sheldon S. Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A. J. 40 (1969); Jerome R. Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957); William A. Lovett, *Tax Subsidies for Merger: Should Mergers be Made to Meet a Market Test for Efficiency?*, 45 N.Y.U. L. REV. 844 (1970).

businesses from the octopus arms of national conglomerates.[257] As a matter of politics, if the voters had to vote for budgeted federal expenditures equal to the tax forgone in a multibillion-dollar merger, few mergers would win voter approval.[258]

To be sure, customizing the target is commonly motivated by nontax factors.[259] The parties could achieve nonrecognition of the gain built into the target's shares by effecting a complete merger of the whole of the target--a full and faithful marriage. The parties avoided the full marriage because the acquirer wanted only a piece of the whole and its reasons are usually sound. In *Elkhorn*, the acquirers wanted only the mines in Maybeury, West Virginia, for which a common management would be convenient; they did not want to bring distant mines under the same management. In *Morris Trust*, the acquirer could not acquire the local bank unless it were stripped of its insurance business. An acquirer that wants only the target's machine shop does not want to marry the whole of the target. Prohibiting customizing would

[257] *See, e.g.,* I.R.C. § 163(e)(5), (i) (deferring, then disallowing nonrecognition of accrued but unpaid interest in leveraged buyouts); I.R.C. § 172(b)(1)(E), (h) (preventing interest incurred in a leveraged buyout from providing net operating loss carrybacks); I.R.C. §§ 280G, 4999 (anti-golden parachute provisions); I.R.C. § 5881 (anti-greenmail provisions).

[258] *Cf.* Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970) (arguing that departures from tax base need to be analyzed as seriously as government checks).

[259] The term "commonly" is used (rather than "always") because cherry picking could be motivated, in part, by tax factors. A target corporation wants a taxable sale of assets with a basis higher than fair market value in order to recognize the loss and a simultaneous transfer of assets with built-in tax gain in a nonrecognition transaction.

block some mergers, because of the tax cost, that make business sense. Still, reorganization law works within the framework in which the government can collect tax only on a realization before death. Since realizations are its only source of revenue, the government will need to collect tax on many realizations that have a very substantial nontax justification.

In 1986, Congress left the 1982 ALI proposals on the table insofar as the proposals would liberalize reorganizations. The basic ALI proposals were submitted to the Senate Finance Committee by its staff in 1985,[260] and repeal of *Elkhorn* was included in the submitted portions.[261] In the Tax Reform Act of 1986, Congress picked up those parts of the proposals which would strengthen the tax base or raise revenue,[262] while leaving behind the parts of the proposals, including the repeal of *Elkhorn*, that would lose revenue or contract the tax base. Some have argued that Congress' taking only the pro-government fraction of the ALI 1982 proposals was a breach of a compromise reached within the

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[260] *See* S. REP. NO. 99-47, at ?? (1985).

[263] *Id.* at 113 (proposing I.R.C. § 361(c)(1)(B), which would require acquisition of substantially all of the target corporation's assets "immediately" before acquisition). *See also* Lee Shepard, *Yin and Ginsburg Hint at Senate Finance Subchapter C Reforms*, 26 TAX NOTES (TA) 1181, 1181 (Mar. 25, 1985) ("Finance would . . . [do] away with the rule of *Helvering v. Elkhorn* . . . . 'Immediately means what it says in this proposal,' commented Ginsburg[.]").

[264] *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 621, 100 Stat. 2085 (limiting net operating loss carryforwards; adapted from FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, *supra* note 237); § 631 (recognizing gains and losses for property distributions in corporate liquidations; adapted from FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, *supra* note 237).

ALI.[263] The decision to leave behind the liberalizers, however, was very much in tune with the grand scheme of the 1986 Act, which was to expand the tax base so that the tax rates could come down.[264] It is the high tax rates, rather than the comprehensive tax base, that causes the deadweight damage to the economy from taxation.[265] In the period following the 1986 Act, Congress was worried about reining in corporate acquisitions, so that liberalizing the reorganization rules had no appeal.[266] The 1986 Reform Act directed Treasury to return to Congress with a study of proposals to reform Subchapter C,[267] but when Treasury returned with its study, it was with a plan for general integration of the corporate and individual income taxes, rather than for a

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[265]*See* Harold R. Handler, *Budget Reconciliation and the Tax Law: Legislative History or Legislative Hysteria?*, 37 TAX NOTES (TA) 1259, 1264-65 (Dec. 21, 1987); Bernard Wolfman, *Subchapter C and the 100th Congress*, 33 TAX NOTES (TA) 669 (Nov. 17, 1986).

[266]*See* Albert A. Hunt, *Introduction* to JEFFREY H. BIRNBAUM & ALAN S. MURRARY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM at xv (1987) ("Merging the lower rates of the supply-siders with the base broadening of the liberal tax reformers was the glue that held the 1986 tax bill together[.]").

[267]*See* JOSEPH STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR ?? (1986) (explaining that the magnitude of deadweight losses increases by the square of the tax). As a result, countervailing taxes reduce deadweight losses.

[266]*See* Ronald A. Pearlman, *The Political Environment of Corporate Tax Reform*, *in* CORPORATE TAX REFORM, *supra* note 198, at 36 (if "we are going to hear expressions of concern from Members of Congress about the level of merger and acquisition activity--about this 'merger mania'--then . . . when a bunch of corporate tax lawyers go prancing to the Hill arguing economic efficiency and transactional simplification, their visit is going to be met with considerable suspicion").

[267]*See* Tax Reform Act, § 634, 100 Stat. 2085, 2282.

liberalization of the tax-free reorganization.[268] Current proposals to reduce tax on capital call for reduction or elimination of tax on capital generally, but do not focus specially on corporate reorganizations.[269]

V. CONCLUSION

The "C" reorganization and the triangular merger under current law must transfer substantially all of the assets of the target. That rule has been interpreted, in a "functional test," to mean that all of the operating assets of the historic business of the target must pass over into the fusion or marriage corporation. Reorganization treatment is understood not to be available for disguised sales of business fragments or selected assets. Those rules can be defeated with ease in substance, with some respect only in form, if a corporation could contribute business fragments to be sold to a new subsidiary and have the subsidiary become the nominal target. The *Elkhorn* doctrine, looking beyond the borders of a newly-formed corporation and

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[268] *See* U.S. TREASURY DEPARTMENT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE ?? (1992).

[269] *See, e.g.,* NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM, UNLEASHING AMERICA'S POTENTIAL: A PRO-GROWTH, PRO-FAMILY TAX SYSTEM FOR THE TWENTY-FIRST CENTURY 32-33, 55-56 (1996); John Godfrey, *Nunn Touts Consumption Tax Plan; Administration Could be Interested*, 63 TAX NOTES (TA) 1399, 1399 (June 13, 1994) (stating that the Clinton administration "is not necessarily opposed to a capital gains tax cut in the context of tax reform); Barbara Kirchheimer, *Boren and Danforth Unveil Revenue-Neutral Consumption Tax Bill*, 63 TAX NOTES (TA) 1090, 1090 (May 30, 1994) (discussing a proposal to replace the corporate income tax with a "broad-based consumption tax").

insisting that the *historic* business be transferred, limits the reorganization to full and faithful marriages.